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TAX REFORM ACT OF 1969

REPORT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

TO ACCOMPANY

H.R. 13270

TOGETHER WITH

SEPARATE AND INDIVIDUAL VIEWS

November 21, 1969.—Ordered to be printed

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November 21, 1969.—Ordered to be printed

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

REPORT

Together with

SEPARATE AND INDIVIDUAL VIEWS

[To accompany H.R. 13270]

The Committee on Finance, to which was referred the bill (H.R. 13270) to reform the income tax laws, having considered the same, reports favorably thereon with an amendment and recommends that the bill as amended do pass.

I. SUMMARY

The Tax Reform Act of 1969 (H.R. 13270) represents a substantive and comprehensive reform of the income tax laws. As the House committee report suggests, there is no prior tax reform bill of equal substantive scope.

From time to time, since the enactment of the present income tax over 50 years ago, various tax incentives or preferences have been added to the internal revenue laws. Increasingly in recent years, taxpayers with substantial incomes have found ways of gaining tax advantages from the provisions that were placed in the code primarily to aid limited segments of the economy. In fact, in many cases these taxpayers have found ways to pile one advantage on top of another. The committee agrees with the House that this is an intolerable situation. It should not have been possible for 154 individuals with adjusted gross incomes of $200,000 or more to pay no Federal income tax. Ours is primarily a self-assessment system. If taxpayers are generally to pay their taxes on a voluntary basis, they must feel that these taxes are fair.

Moreover, only by sharing the tax burden on an equitable basis is it possible to keep the tax burden at a level which is tolerable for all taxpayers. It is for these reasons that the committee amendments contain some 34 groups of tax reform provisions described in summary fashion at the end of this section.

The committee labored long and diligently to make a careful and comprehensive review of the House bill, yet meet its obligation to the Senate by ordering this bill reported on October 31. On September 4, immediately following the congressional recess, the committee began hearings on this bill which extended over 23 days and in which over 300 witnesses were heard. These hearings cover over 7,000 pages and the committee inserted into the Congressional Record day by day summaries of the statements of the witnesses as they were made to the committee. Following the completion of its public hearings, the committee considered the bill in 16 days of executive session in October. During this time, the committee carefully considered all aspects of the bill, as is indicated by the fact that in these executive sessions there were 457 motions made with respect to specific provisions. Daily press conferences were held during this period to keep the public and the Senate fully informed of the progress of the committee in reaching its decisions.

All these public announcements were compiled and submitted individually to Senators within days after the bill was ordered reported so that they would have the opportunity to learn of the changes proposed by the committee in the House bill. Additionally, the committee prepared a summary of all the provisions to be contained in the bill it had ordered reported. This summary, too, was submitted individually to the Senators. It was the committee's objective to fully inform Senators of the content and purpose of the committee bill with a view toward expediting the formal consideration of the bill by the Senate.

Tax reform changes.—The bill as reported by the committee in a great many respects is substantially similar to the bill as it was passed by the House, reflecting the sharing of a common goal of a fair and more efficient tax system. The measure passed by the House is a vast and comprehensive document and in the committee's opinion represents a very substantial achievement toward a more equitable tax system. However, the committee has made many amendments which change the scope and technical language of the House provisions, add new tax reform measures, and delete some provisions of the House bill. The committee, however, regards its amendments as building on the basic foundation provided by the House bill.

The committee's amendments fall in three basic categories. First, by far the greatest number of the amendments seek to refine the concepts and specific technical language of the House provisions so that these provisions will be more effective in achieving their tax reform purpose. Testimony before the committee in its hearings was particularly helpful in pointing out areas where the language of the House bill needed changing either because of technical problems, or because of its application in types of situations not contemplated by the House action.

In the second category of amendments the committee seeks to achieve a better balance between the equity considerations for taxing a number of items regarded as tax preferences and the economic effects of such taxation. The basic principle underlying the committee's decision in this respect is that preferences should be eliminated or substantially curtailed unless there are overriding considerations which would have a serious impact upon the economy. An example of modifications of the House bill to take national policy considerations into account more fully are the changes made by the committee with respect to the depreciation provisions relating to housing. The House bill recognized the priority of housing over other forms of construction by continuing for housing faster depreciation rules that generally were being withdrawn from other forms of construction. However, the so-called "recapture rules" in the House bill apply to housing and other forms of construction alike. The committee amendment, like the House bill, accords housing faster depreciation rules, but also provides somewhat more generous recapture rules for housing than for other forms of construction by retaining the present law recapture rules for low-income housing and permitting tax-free rollovers of certain investments in this area.

Another example of the committee's attempt to weigh national policy objectives with equity considerations comes in the area of the tax treatment of State and local bond interest. The House bill would have included this interest income in its special limit on tax preferences and in its allocation of deductions. The committee, after extensive hearings on this topic, concluded that in view of the very considerable difficulties State and local governments now are encountering in marketing their bonds and in view of the unprecedented high level of interest rates and present tight money conditions, it was not in the national interest to reduce the marketability of these bonds by imposing any taxes, even indirectly, on State and local bonds. For these reasons, income from State and local bond interest is not included in the base of the minimum tax provided by the committee. The committee is hopeful that its action in excluding the interest on these bonds from the scope of the minimum tax will restore confidence to the tax-exempt bond market and enable State and local governments to continue the important work of improving their services and facilities.

Similarly, the committee's amendments seek to achieve a better balance between the objectives of tax reform and economic incentive than was achieved in the House bill in such areas as capital gains taxation, the treatment of bad debt reserves of financial institutions and, to some extent, in the case of percentage depletion.

The third general category of committee amendments seeks to deal with tax preferences not dealt with in the House bill, or to deal more effectively with those included. Among these is the provision to lower the exclusion for income earned abroad from $20,000 or $25,000 to $6,000, the provision to treat what are essentially self-employed individuals the same way for retirement plan purposes whether they are using so-called professional corporations or are conducting their businesses as self-employed persons, limiting the life of the tax-free status of private foundations to 40 years, denying a deduction for the penal portion of treble damage payments in the case of antitrust violations, and recognizing gain when a corporation distributes property which has appreciated in value in redemption of its own stock.

In addition, the committee has substantially reduced inequities in our corporate tax structure by substituting for the House provision which dealt only with tax preferences of individuals a new minimum tax which deals with tax preferences received by corporations and individuals alike. At the same time, the minimum tax adopted by the committee not only raises more revenue than the House provision but also does not distinguish among those with preference income on the basis of the amount of other income they have which is subject to tax.

Despite the comprehensive scope of this tax bill, the committee recognizes that much remains to be done. In some cases, income tax problems had to be postponed for further analysis and study. Moreover, the entire area of estate and gift tax reform lies outside the scope of this bill and remains an area for future consideration.

Although the committee has made a substantial number of amendments to the House bill, the overall balance of tax reform is substantially the same in the two bills. Based upon long-run impacts, the committee amendments raise $6.65 billion in revenue versus $6.91 billion under the House bill. A summary of the major tax reform proposals in the bill with the principal modifications made by the committee is shown below.

Tax relief changes.—In the area of tax relief, this bill very substantially improves the tax structure. When the relief measures are fully implemented in 1972, they will represent a reduction of nearly $9 billion. This relief, combined with the tax reform measures, provides substantial tax reductions in the lowest income brackets, with decreasing reductions for those with higher incomes, until finally, for the income brackets of $100,000 or over, large tax increases result from the reform measures in this bill.

On an overall basis, this bill provides an average reduction in tax liability of slightly over 10 percent, but for those with adjusted gross incomes of $3,000 or less, the average reduction is 66 percent and for those with incomes between $3,000 and $5,000 the average reduction is 30 percent. The changes in tax liability provided by this bill are shown clearly in table 3 of this report which can be summarized as follows:

Adjusted gross income (in thousands):	*Percentage tax increase or decrease from committee amendments*
$0 to $3	−66.1
$3 to $5	−30.3
$5 to $7	−17.0
$7 to $10	−10.9
$10 to $15	−10.3
$15 to $20	−8.6
$20 to $50	−7.2
$50 to $100	−4.8
$100 and over	+2.6
Total	−10.1

The tax reduction in this bill is carefully tailored to deal with what the committee considers to be important national objectives:

(1) Removal of all income tax from the poor and substantial reductions of the income tax for the near poor.

(2) Obtaining substantial simplification of the tax structure for the great bulk of taxpayers by encouraging 11.6 million per-

sons to shift from returns with itemized deductions to returns with larger standard deductions. This will increase from 58 percent to 72 percent the proportion of all the returns using the simple standard deduction.

(3) Special tax reductions for single persons to insure that their tax burden in no event is more than 20 percent above that of married couples with comparable income. At the present time, in some cases they are paying 40 percent more than married couples with the same taxable income.

(4) Providing tax rate reductions for all taxpayers and all income levels of at least 5 percent. Since this is in addition to the low-income allowance and higher standard deduction, the result (as indicated in the tabulation presented above) is very much larger tax reductions for those in the low- and middle-income groups.

Fiscal policy and revenue implications.—The size of the tax reduction provided in the committee amendments—$9 billion when fully effective in 1972—has been carefully designed from the standpoint of its fiscal implications. (See table 1.) These are particularly important in the period immediately ahead in view of the fact that inflationary pressures are still persisting. The tax reform and tax relief provisions in this bill, even without the effect of the extension of the surcharge and excise taxes, are expected to increase revenues by approximately $2.2 billion in the calendar year 1970 and result in a net tax reduction of only $500 million in the calendar year 1971. In fact, if the effect of continuing the surcharge at a 5 percent rate for the first six months of 1970 and the excise tax extensions on automobiles and communications services are also taken into account, the revenue effect of the bill is to raise $6.5 billion in 1970 and $300 million in 1971. The committee believes that it is important to maintain this fiscal balance if this tax measure is not to refuel the inflationary fires. In terms of fiscal year effect, the provisions of this bill are estimated to increase receipts by $3.4 billion in 1970 and $3.0 billion in the fiscal year 1971 (including the surcharge and excise tax changes).

In the long run, the revenue raised by the reform measures included in the committee amendments is expected to amount to about $3.4 billion, before taking into account the repeal of the investment credit. After the repeal of the credit is taken into account, the revenue raised by the committee amendments amounts to $6.65 billion.

The revenue reductions provided to individuals by the committee amendments in the long run (also shown in table 1) are expected to amount to $9 billion, or $2.3 billion more than the revenue-raising measures included in the committee amendments.

All of the revenue figures shown in this report are based on present levels of income. No attempt is made to take into account probable growth in general receipts or possible further revenue increases from the reform provisions of the bill as the economy grows or, on the other hand, possible further increases in the effect of the tax reduction provisions of the bill (because of the same factors). It is recognized that this growth will occur, but in terms of today's economy it is believed that current income level figures are the more useful since there is no satisfactory way of evaluating expenditure levels which may also change in the future.

TABLE 1.—BALANCING OF TAX REFORM AND TAX RELIEF UNDER H.R. 13270—CALENDAR YEAR TAX LIABILITY

[In millions of dollars]

	1970	1971	1972	1974	Long run
A. AS APPROVED BY THE SENATE COMMITTEE ON FINANCE					
Tax reform program under Finance Committee bill	+1,400	+1,655	+1,880	+2,440	+3,350
Repeal of investment credit	+2,500	+2,990	+2,990	+3,090	+3,300
Tax reform and repeal of investment credit	+3,900	+4,645	+4,870	+5,530	+6,650
Income tax relief under Finance Committee bill	[1] −1,712	−5,144	−8,968	−8,968	−8,968
Balance between reform (+) and relief (−) under Finance Committee bill [1]	+2,188	−499	−4,098	−3,438	−2,318
Extension of surcharge and excises	+4,270	+800	+800		
Total	+6,458	+301	−3,298	−3,438	−2,318
B. AS PASSED BY THE HOUSE OF REPRESENTATIVES					
Tax reform program under House bill [1]	+1,665	+2,080	+2,215	+2,650	+3,605
Repeal of investment credit	+2,500	+3,000	+3,000	+3,100	+3,300
Tax reform and repeal of investment credit [1]	+4,165	+5,080	+5,215	+5,750	+6,905
Income tax relief under House bill	[1] −1,912	[1] −6,568	−9,273	−9,273	−9,273
Balance between reform (+) and relief (−) under House bill [1]	+2,253	−1,488	−4,058	−3,523	−2,368
Extension of surcharge and excises	+4,270	+800	+800		
Total	+6,523	−688	−3,258	−3,523	−2,368

[1] Revised.

TAX REFORM MEASURES

1. *Private Foundations.*—The committee amendments, like the House bill, make substantial changes in the treatment of foundations. The permissible activities of tax exempt private foundations are tightened to prevent self-dealing between the foundations and their substantial contributors, to require the distribution of income for charitable puposes, to limit their holdings of private businesses, to give assurance that their activities are properly restricted as provided by the exemption provisions of the tax laws, and to provide certainty that investments of these organizations are not jeopardized by financial speculation.

In addition, to help defray the costs of enforcing the tax laws regarding private foundations, they are called upon to pay a small annual audit-fee tax of one-fifth of 1 percent of their noncharitable assets (instead of the 7½ percent tax on investment income under the House bill). Moreover, the life of the income tax exemption for private foundations is limited to 40 years (beginning in 1970 for existing foundations).

2. *Tax-exempt Organizations Generally.*—Under both versions of the bill, unrelated activities of tax-exempt organizations are restricted. First, the activities of exempt organizations generally are limited so that if they participate in debt-financed property acquisition (which, in effect, allow a sharing of their exemption with private businesses) they must pay tax on the income from the debt-financed portion of the property. Second, the unrelated business income tax is extended to virtually all tax-exempt organizations not previously covered, including churches (after 1975). Third, the regular corporate tax is extended to the investment income of certain tax-exempt organizations set up primarily for the benefit of their members, such as social

clubs and employees' beneficiary associations. Unlike the House bill, the committee amendments do not extend this tax to fraternal beneficiary associations and to fraternal lodge organizations.

3. *Charitable Contributions.*—The committee amendments and the House bill substantially restructure the charitable contributions deduction. The general charitable deduction limit is increased to 50 percent (except for gifts of appreciated property) and the unlimited charitable deduction is phased out over a 5-year period. The extra tax benefits derived from charitable contributions of appreciated property are restricted under the committee amendments in the case of gifts to private foundations and gifts of ordinary income property (but not, as under the House bill, in the case of bargain sales or gifts of future interests and tangible personal property, such as art works). Finally, the 2-year charitable trust rule is repealed and a number of changes are made to limit charitable deductions for gifts of the use of property and in the case of charitable remainder and charitable income trusts.

4. *Farm Losses.*—The committee amendments limit the current deductibility of farm losses to one-half of the loss. For an individual, the limitation applies only to losses over $25,000 and only if his nonfarm income is over $50,000. For a corporation, the limitation applies to all its losses. Losses not currently deductible may be carried over and used against future farm ordinary income. This is in place of the complicated excess deductions account approach of the House. Both versions of the bill provide for the recapture of depreciation of the sale of livestock and a more effective treatment of hobby losses. The committee amendments extend the holding period for cattle and horses, but not to other livestock as done by the House. In addition, provision is made for the recapture of soil and water conservation or land clearing expenditures upon the sale of farmland.

5. *Moving Expenses.*—Both versions of the bill extend the moving expense deduction (subject to a $2,500 ceiling) in the case of job-related moves to include costs of house-hunting trips, temporary living expenses prior to locating a new home, and expenses of selling an old home or buying a new one. The committee amendments also extend the moving expense deduction to self-employed persons.

6. *Minimum Tax.*—The committee amendments provide a minimum additional tax of 5 percent on the sum of every individual's or corporation's tax preferences in excess of $30,000. This is a simple measure which replaces the relatively complex limit on tax preferences and allocation of deductions provisions of the House bill. The committee's minimum tax applies to both individuals and corporations. The House measure applied only to individuals.

7. *Income Averaging.*—Both versions of the bill make the present income averaging provision more generally available. The committee amendments do not extend income averaging to additional types of income as did the House.

8. *Restricted Property.*—Under both versions of the bill, restricted and other property is taxed at the time of receipt unless there is a substantial risk of forfeiture. In this event, the property is taxed when the possibility forfeiture ends at its full value at that time.

9. *Accumulation Trusts.*—Beneficiaries of accumulation trusts (including multiple trusts) are to be taxed under both versions of the bill

on distributions of accumulated income in substantially the same manner as if the income had been distributed to them when earned by the trust. This prevents a special type of income splitting.

10. *Multiple Corporations.*—The committee amendments withdraw multiple surtax exemptions (and other multiple benefits) in the case of related corporations over a 5-year period (rather than over the 8-year period provided by the House).

11. *Corporate Mergers.*—Under both versions of the bill, tests are provided to determine when "debt" is in fact "equity" so as to make the interest deduction unavailable where this "debt" is used in acquiring other companies. In addition, the use of the installment method of reporting gains is restricted where readily marketable debt is received (but the requirement of periodic installment payments provided in the House bill is not included). Limiting changes also are made in the treatment of original issue discount and other situations. The committee amendments also provide the Treasury Department with authority to issue guidelines distinguishing between debt and equity for all tax purposes.

12. *Stock Dividends.*—The House bill and the committee amendments provide for the taxation of stock dividends where one group of shareholders receives a distribution in cash while the proportionate interests of other shareholders in the corporation are increased.

13. *Commercial Banks.*—The committee amendments reduce the tax deductions of commercial banks for additions to reserves for bad debt losses (the permissible size of the reserves is reduced from 2.4 percent to 1.8 percent of loans; the House would have based the level on the bank's experience). Both versions of the bill also withdraw capital gains treatment for bonds held by banks in their banking business.

14. *Mutual Savings Banks and Savings and Loan Associations.*—Both versions of the bill revise the tax treatment of mutual savings banks and savings and loan associations by substantially reducing the special bad debt deductions presently available to these types of institutions (60 percent of taxable income under present law, 50 percent under the committee amendments and 30 percent under the House bill).

15. *Depreciation in Case of Regulated Industries.*—Under the House bill and committee amendments, depreciation in the case of certain regulated industries is limited for new property to straight line depreciation, unless the appropriate regulatory agency permits the company to take accelerated depreciation, and "normalize" its tax deduction. For existing property, no faster depreciation may be taken than is presently claimed. Generally, companies already on "flow through" cannot change without permission of the regulatory agency, but the committee amendments permit such a company to elect within a 180-day period to shift to the straight line method with or without regulatory agency permission.

16. *Depreciation in Computing Earnings and Profits.*—Both versions of the bill provide that in computing earnings and profits—which determine whether or not distributions are taxable as dividends—corporations must make the computation on the basis of straight line depreciation. This prevents the passing of the tax benefit of accelereated depreciation through to stockholders in the form of

tax-free dividends. The committee amendments do not apply this rule to foreign corporations.

17. *Natural Resources.*—The committee amendments reduce the percentage depletion rate for oil and gas wells from 27½ percent to 23 percent (the House bill reduced this rate to 20 percent, eliminated percentage depletion on foreign oil and gas, and also reduced most other depletion rates by about 25 percent). The committee amendments also increase the net income limitation on depletion for oil and gas from 50 percent to 65 percent for producers with less than $3 million of gross income and to 70 percent for gold, silver, and copper. Both versions of the bill provide that carved out production payments and retained production payments (including ABC transactions) are to be treated as if the payments were loans by the owner of the payment to the owner of the mineral property. Generally, the carve-out rule prevents production payments from artifically increasing percentage depletion deductions and foreign tax credits. The retained production payment rule eliminates the possibility of purchasing mineral property with money which is not treated as taxable income of the buyer. Finally, recapture rules are applied to mining exploration expenditures not presently subject to recapture.

18. *Alternative Capital Gains Tax Rate.*—The committee amendments eliminate the 25-percent alternative capital gains tax rate for individuals except with respect to $140,000 of gains in the case of individuals who do not have significant tax preferences. For individuals in the top tax bracket this means that the rate on capital gains may rise to 32½ percent under the new rate structure in the bill. (The House bill eliminated the alternative rate entirely.) In addition, both versions of the bill increase the corporate alternative capital gains tax rate from 25 to 30 percent.

19. *Capital Gains and Losses.*—The treatment of capital gains and losses is revised in several respects under both versions of the bill. The more important of these are listed below. First, long-term capital losses of individuals are reduced by 50 percent before they offset ordinary income. Second, the sale of papers, etc., by a person whose efforts created them (or for whom they were produced) is to give rise to ordinary income. Third, employers' contributions after 1969 to pension plans paid out as part of a lump-sum distribution are to be taxed as ordinary income. Fourth, transfers of franchises are not to be treated as giving rise to capital gains if the transferor retains significant rights. The committee amendments also deny capital gains treatment for contingent payments under franchises and extend the treatment accorded franchises to trademarks and trade names. The committee amendments also provide a 3-year capital loss carryback for corporations. The committee amendments do not, however, increase the capital gain holding period to 12 months (as the House bill does).

20. *Real Estate Depreciation.*—Both versions of the bill revise real estate depreciation allowances to limit their use as a tax shelter. The 200-percent declining balance (or sum-of-the-years digits) method is limited to new housing. Other new real estate is limited to 150-percent declining balance depreciation. All used property acquired in the future is limited to straight-line depreciation. A special 5-year amortization deduction is provided for certain rehabilitation expenditures on low-income rental housing. Finally, the present depreciation recapture

rules are revised to provide generally that gain on the sale of real estate is to be treated as ordinary income to the extent of depreciation in excess of straight-line depreciation. The committee amendments, however, reduce recapture in the case of new residential housing and retain the present recapture rule for low-income publicly assisted housing.

21. *Subchapter S Corporations.*—In the case of subchapter S corporations (that is, corporations treated somewhat like partnerships), both versions of the bill limit the tax deductions for amounts set aside under qualified pension plans for shareholder-employees to 10 percent of the compensation paid or $2,500, whichever is smaller.

22. *Qualified Pension Plans of Professional Corporations.*—The committee amendments require shareholder employees of professional service corporations to include in gross income contributions paid on their behalf to qualified pension plans, to the extent the contributions exceed 10 percent of their compensation or $2,500, whichever is less. This is to prevent the avoidance of the limitations imposed on pension plans of self-employed persons (H.R. 10 plans).

23. *Arbitrage Bonds.*—Both versions of the bill deny the Federal income tax exemption for interest on so-called arbitrage bonds of State and local governments.

24. *Amounts Received Under Insurance Contracts for Certain Living Expenses.*—Under the committee amendments, an individual whose residence is damaged or destroyed by casualty is not to be taxed on insurance reimbursements for the extra living expenses he and his family incur because of the loss of use of his residence.

25. *Deductibility of Treble Damages, Fines, Penalties, and So Forth.*—The committee amendments codify the judicial rule that deductions are not to be allowed for fines paid for the violation of any law and deny deductions for two-thirds of treble damage payments under the antitrust laws, for bribes of public officials and for unlawful bribes or "kickbacks."

26. *Deduction of Antitrust Damage Recoveries.*—The committee amendments provide that recoveries of antitrust damages are not to be taxed to the extent the related losses did not produce a tax benefit.

27. *Corporate Stock Redemptions with Appreciated Property.*—Under the committee amendments, a corporation is to be taxed on the appreciation in value of property it uses to redeem stock from its shareholders.

28. *Reasonable Accumulations by Corporations.*—The committee amendments give protection from the special tax on accumulated earnings where a corporation accumulates amounts to redeem a deceased shareholder's stock to pay death taxes or to redeem stock from a private foundation which must be disposed of as an excess business holding under the bill.

29. *Insurance Companies.*—The committee amendments revise three aspects of the treatment of life insurance companies: the treatment of contengency reserves under group insurance contracts, the limitation on the carryover of losses by an insurance company which changes the nature of its insurance business, and the application of the so-called phase III tax in the case of corporate spin-offs.

30. *Exclusion for Income Earned Abroad.*—The committee amendments reduce from $20,000 (or $25,000 in certain cases) to $6,000 the

amount of foreign source earned income which a U.S. citizen may exclude from income if he is a bona fide resident of a foreign country or temporarily abroad for 17 out of 18 months.

31. *Penalties for Failue To Pay Tax or Make Deposits.*—The committee amendments provide a penalty of 5 percent a month (up to 25 percent) for a failure to pay income tax, when due, unless there is reasonable cause. Current high interest rates provide a temptation to borrow from the Government by underpaying taxes which bear interest at only 6 percent.

32. *Reporting of Medical Payments.*—Under the committee amendments, information reporting is required with respect to payments to doctors, dentists, etc., by insurance companies and by the Government under medicare and medicaid. This reporting is required whether the payment is made directly to the doctor or dentist or is made indirectly through the patient.

33. *Tax Court.*—The committee amendments establish the Tax Court as a court under Article I of the Constitution and provide a simplified, relatively informal Tax Court procedure for small claims cases.

34. *Miscellaneous Provisions.*—The committee amendments also deal with the deductibility of accrued vacation pay, the net operating loss carryback for banks for cooperatives, the treatment of mutual fund shares under periodic payments plans, the exception from foreign base company income where the purpose of the corporation and the transaction was not to achieve a substantial reduction in income taxes, the treatment of gain on sales of certain low-income housing projects, and the treatment of cooperative per-unit retain allocations paid in cash.

EXTENSION OF SURCHARGE AND EXCISES, TERMINATION OF INVESTMENT CREDIT AND CERTAIN AMORTIZATION PROVISIONS

1. *Surcharge.*—Both versions of the bill extend the income tax surcharge, at a 5-percent rate, from January 1, 1970, through June 30, 1970.

2. *Excises.*—The reductions in the excise taxes on passenger automobiles and communication services scheduled under present law are postponed for 1 year under both versions of the bill.

3. *Investment Credit.*—Under both versions of the bill, the investment credit is repealed.

4. *Pollution Control.*—Five year amortization is provided under both versions of the bill for certified pollution control facilities. The committee amendments limit the provision to facilities installed on existing plants and reduce the amortizable amount in the case of facilities with long useful lives.

5. *Railroad Rolling Stock, etc.*—Five-year amortization is provided under the committee amendments for railroad rolling stock (including rolling stock of lessors leasing to railroads). Under the House bill, the amortization was for 7 years, did not apply to locomotives, and did not apply to lessors. The committee amendments also provide for the deduction of repairs to railroad rolling stock not in excess of 20 percent of cost and for 50-year amortization of railroad gradings and tunnel bores.

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ADJUSTMENTS OF TAX BURDEN FOR INDIVIDUALS

1. *Percentage Standard Deduction.*—Both versions of the bill increase the percentage standard deduction over a 3-year period from 10 to 15 percent of adjusted gross income and the maximum standard deduction from $1,000 to $2,000. This rate and amount are effective for 1972 and later years. The deduction is 13 percent with a maximum of $1,400 in 1970, and 14 percent with a maximum of $1,700 in 1971.

2. *Minimum Standard Deduction and Low-Income Allowance.*—Both versions of the bill increase the minimum standard deduction to $1,100 by adding a low-income allowance to the present minimum. This low-income allowance is phased out for 1970 and 1971 for the income levels above the nontaxable level. The House bill would have applied the phaseout only in 1970. After 1971, the full $1,100 minimum allowance will be available for all taxpayers.

3. *Filing Requirements.*—Under the committee amendments, the income level at which a tax return must be filed is raised to $1,700 for a single taxpayer, $2,300 for a married couple (or single person age 65 or over), $2,900 for a married couple where one is age 65 or over, and $3,500 in the case of a married couple where both are age 65 or over. The filing requirement remains at $600 for spouses filing separate returns.

4. *Tax Treatment of Single Persons.*—The committee amendments provide a new rate schedule for single persons which produces a tax liability for single persons no more than 20 percent above that of married couples. A new rate schedule is also provided for heads of households which is halfway between the new rate schedule for single persons and the rate schedule for married couples. The House bill would have permitted widows and widowers regardless of age and single persons age 35 and over to use a rate schedule equivalent to the present head-of-household schedule.

5. *Rate Reductions.*—Under the committee amendments individuals will receive tax rate reductions totaling almost $4.5 billion annually by 1972. The 1972 tax rates provide a rate reduction of 5 percent or more in all brackets. When fully effective in 1972, the rate reductions under the committee amendments are the same as under the House bill. However, about one-third of the committee's rate reduction will occur in 1971, and the remaining two-thirds in 1972. The House bill divides the rate reductions evenly between 1971 and 1972.

6. *Computation of Tax by Internal Revenue Service.*—The committee amendments raise the income levels with respect to which the Internal Revenue Service may compute a taxpayer's income tax and allow this procedure to be made more generally available.

7. *Withholding Procedures.*—The committee amendments make a number of changes in the present income tax withholding procedures to provide greater flexibility, to broaden the allowance of additional withholding allowances for excess itemized deductions, to exempt from withholding requirements individuals, such as college students, who do not have a tax liability for the year, to provide for withholding on supplemental unemployment benefits, and to allow voluntary withholding on certain types of payments.

II. REASONS FOR THE BILL

The preferences in the present tax laws have accumulated over the 56 years the present income tax law has been in effect. Although from time to time various preferences have been removed, other preferences also were added. As a result, in many cases, although the tax preferences may have been justified at the time of their inception, it is not clear that they are needed or desirable in today's economy.

The problem has become especially serious since tax practitioners have found ways of packaging these preference provisions, sometimes making a series of them available with respect to a high-paid executive. How serious these problems are is shown by the fact that in 1966 there were 154 persons with adjusted gross income in excess of $200,000 who paid no income tax. Twenty-one of these had incomes over $1 million. These 154 returns (along with other tax cases involving low effective rates) have been studied in detail in order to find out the reasons for their nontaxable status.

The analysis showed that in most cases the nontaxable status arose from a combination of several factors. The most important single cause of nontaxability for this group was the presence of itemized deductions, which totaled over $130 million or 116 percent of adjusted gross income. One group of these taxpayers benefited most from the unlimited charitable contribution deduction (49 cases). In fact, the single most important itemized deduction for the nontaxable group was the charitable contribution deduction, amounting to nearly $79 million, of which $55 million (or 70 percent) was property, the bulk of which represented untaxed appreciation. Others benefited from such items as real estate depreciation, the interest deduction, the excess of percentage over cost depletion and intangible drilling and development expenses, and farm losses. Many were nontaxable because they were able to exclude one-half of capital gains from their income and offset all their itemized deductions against the remaining income subject to tax.

The returns of taxpayers who were taxable but paid low effective rates of tax also were examined. The most important reason for the low effective tax rate paid by these taxpayers was the combination of the excluded half of capital gains and itemized deductions which were offset against their income subject to tax.

The fact that present law permits a small minority of high-income individuals to escape tax on a large proportion of their income has seriously undermined the belief of taxpayers that others are paying their fair share of the tax burden. It is essential that tax reform be obtained not only as a matter of justice but also as a matter of taxpayer morale. Our individual and corporate income taxes, which are the mainstays of our tax system, depend upon self-assessment and the cooperation of taxpayers. The loss of confidence on their part in the fairness of the tax system could result in a breakdown of taxpayer morale and make it far more difficult to collect the necessary revenues. For this reason alone, the tax system should be improved.

Tax reform is necessary both to be certain that those with substantially the same incomes are paying substantially the same tax and also to make certain that the graduated income tax structure is working fairly as between different income levels. Present law, because of various tax preferences, permits a minority of high-income taxpayers to escape payment of tax on a very large proportion of their economic income by arranging to receive various kinds of tax-free income and by taking advantage of a combination of special tax deductions. As a result, many high-income individuals pay tax at lower effective rates than those with relatively modest incomes.

Tax reform is also necessary in order to make general tax reductions possible. Only if all individuals and corporations are bearing their fair share of the tax burden is it possible to have a sufficiently broad-based tax to obtain the necessary revenue without unduly burdening some classes of taxpayers. The committee amendments are based on this principle. The committee takes the revenue obtained from tax reform and provides tax réductions on a wide basis. In the lower income groups, the tax reductions are provided in the form of a substantial low-income allowance and through a larger standard deduction. In addition, rate reduction of at least 5 percent is provided.

Tax reform is also esssential because the present defects in the tax structure impede the proper functioning of the economic system. These defects encourage legal and technical efforts to minimize taxes. In addition, these defects encourage transactions for tax purposes rather than for economic reasons. They result in a misallocation of resources and may misdirect investment into those areas where special tax benefits are provided. Often, incentives to investments in these areas may have been desirable at one time but are no longer needed or are needed to a lesser extent. This is true, for example, in the case of the investment credit which was adopted in 1962 as a method of attracting investment in plant and equipment but which in the last 2 years appears to have been an important factor in overheating the capital goods industry.

As the committee analyzed the various preferences in the tax laws, it became apparent that to an unfortunate extent economic activity appears to be organized in a manner designed to maximize the tax benefits from the various tax provisions. In each case, it is contended that removal of the special tax preferences will result in serious dislocations for the economy. The committee has to some degree recognized this type of argument by, in many cases, phasing in the remedial tax treatment over a period of years. Additionally, it has not entirely removed the tax preferences even after this transition period in cases where there is a good possiblity that such action might cause serious dislocations in the economy. It has not, for example, removed much of the advantage of double-declining balance depreciation in the case of new housing.

Also, despite the view of some that investment in tax-exempt State and local bonds is a tax-avoidance device, the committee decided to impose no burdens on the receipt of such interest either directly or indirectly. This action was taken because of the committee's concern with the problems of State and local governments in financing their activities and its recognition of the importance of placing no impediments in the way of such financing.

Tax reform may mean some additional complications for those taxpayers who have used various devices to avoid or minimize their tax burden. This certainly was true of the limit on tax preferences and allocation of deductions under the House provisions. The committee, however, recognizing the complexity of these two measures, has substituted a simpler 5 percent minimum tax on tax preferences, which is in addition to the regular income tax. This should prove to be a more easily understood provision than either of the two measures in the House bill. In any event, the smaller taxpayer will find that tax reform means simplification because tax reform will increase the possibility of his using the simple standard deduction and minimum standard deduction. None of these tax-simplifying measures could have been adopted by the committee were it not for the revenue provided by the corrective effect of the tax reform measures in other areas of the tax law. In the long run, tax reform should also lead to simplification by redirecting effort from tax avoidance to productive economic effort.

The committee amendments also include measures repealing the investment credit, extending the surcharge at a 5-percent rate for the first half of 1970, and postponing the scheduled excise tax reductions on automobiles and communications services for another year. It took this action with respect to the investment credit because it considers its repeal an essential reform measure. The additional 6-month extension of the surcharge, on the other hand, and the continuation of the excise taxes on communications services and automobiles, are viewed as temporary revenue measures which are needed primarily to dampen inflationary pressures in the period immediately ahead and to provide sufficient revenues for a balanced unified budget.

III. REVENUE EFFECTS

Table 2 shows the manner in which the committee has balanced tax reform and tax relief as well as the balance achieved in the House bill. As indicated by this table, under the committee amendments, revenues from the tax reform program are expected to increase from $1.4 billion in 1970 to $3.4 billion when fully effective. This is without regard to the revenue impact of repealing the investment credit, which increases revenues $2.5 billion in 1970 and $3.3 billion per year in the long run. Taken together, these revenue increases represent $3.9 billion of additional revenue in 1970 and $6.7 billion of additional revenue in the long run.

Against this reform program which raises revenue, the committee has balanced a tax reduction program, which becomes fully effective in 1972. This accounts for a tax reduction of $1.7 billion in 1970, $5.1 billion in 1971, and $9.0 billion in 1972 and thereafter. The components of this tax-reduction program consist in 1972 of a tax reduction of $625 million in the form of a low-income allowance, the removal of the phaseout on this low-income allowance which accounts for a further revenue reduction of $2 billion, and an increase in the standard deduction of $1.4 billion. The rate reductions provided in the committee amendments in 1971 and 1972 account for an additional revenue loss of $4.5 billion. A further revenue loss of $445 million is attributable to the reduced tax rate schedule made available for single persons.

TABLE 2.—BALANCING OF TAX REFORM AND TAX RELIEF UNDER H.R. 13270—CALENDAR YEAR LIABILITY

[In millions of dollars]

	1970	1971	1972	1974	Long run
A. AS APPROVED BY THE SENATE COMMITTEE ON FINANCE					
Tax reform program under Finance Committee bill	+1,400	+1,655	+1,880	+2,440	+3,350
Repeal of investment credit	+2,500	+2,990	+2,990	+3,090	+3,300
Tax reform and repeal of investment credit	+3,900	+4,645	+4,870	+5,530	+6,650
Income tax relief:					
Low-income allowance	-625	-625	-625	-625	-625
Change in phaseout on low income allowance		-1,062	-2,027	-2,027	-2,027
Increase in standard deduction [1]	[2] -1,087	-1,325	-1,373	-1,373	-1,373
Rate reduction		-1,687	-4,498	-4,498	-4,498
Tax treatment of single persons		-445	-445	-445	-445
Total tax relief under Finance Committee bill	[2] -1,712	-5,144	-8,968	-8,968	-8,968
Balance between reform (+) and relief (-) under Finance Committee bill	+2,188	-499	-4,098	-3,438	-2,318
Extension of surcharge and excises	+4,270	+800	+800		
Total	+6,458	+301	-3,298	-3,438	-2,318
B. AS PASSED BY THE HOUSE OF REPRESENTATIVES					
Tax reform program under House bill [2]	+1,665	+2,080	+2,215	+2,650	+3,605
Repeal of investment credit	+2,500	+3,000	+3,000	+3,100	+3,300
Tax reform and repeal of investment credit [2]	+4,165	+5,080	+5,215	+5,750	+6,905
Income tax relief:					
Low-income allowance	-625	-625	-625	-625	-625
Removal of phaseout on low income allowance		-2,027	-2,027	-2,027	-2,027
Increase in standard deduction [1]	[2] -1,087	[2] -867	-1,373	-1,373	-1,373
Rate reduction		-2,249	-4,498	-4,498	-4,498
Maximum 50-percent rate on earned income	-200	-150	-100	-100	-100
Intermediate tax treatment for certain single persons, etc.		-650	-650	-650	-650
Total tax relief under House bill	[2] -1,912	[2] -6,568	-9,273	-9,273	-9,273
Balance between reform (+) and relief (-) under House bill [2]	+2,253	-1,488	-4,058	-3,523	-2,368
Extension of surcharge and excises	+4,270	+800	+800		
Total	+6,523	-688	-3,258	-3,523	-2,368

[1] 1970: 13 percent, $1,400 ceiling; 1971: 14 percent, $1,700 ceiling; 1972: 15 percent, $2,000 ceiling.
[2] Revised.

Table 3 shows the combined individual income tax liability under present law, the change in tax liability under the House bill and under the committee amendments and the percentage tax reductions resulting from these changes. An analysis of this table indicates that under the committee amendments there will be an average 66-percent tax reduction for those in the zero to $3,000 adjusted gross income class, a 30-percent reduction for those in the $3,000 to $5,000 adjusted gross income class, a reduction of 17 percent for those in the $5,000 to $7,000 adjusted gross income class, and a tax reduction in higher income brackets beginning at 11 percent for incomes of $7,000 to $10,000 and gradually decreasing to 5 percent for incomes of $50,000 to $100,000. For income levels above $100,000, because of the substantial impact of the tax-reform program, the table indicates that instead of a tax reduction of approximately 5 percent, there will be a tax increase of nearly 3 percent.

TABLE 3.—INDIVIDUAL INCOME TAX LIABILITY—TAX UNDER PRESENT LAW AND AMOUNT AND PERCENTAGE OF CHANGE UNDER REFORM AND RELIEF PROVISIONS UNDER H.R. 13270 WHEN FULLY EFFECTIVE

Adjusted gross income class	Tax under present law [1] (millions)	Increase (+) decrease (–) from reform and relief provisions: Amount (millions)	Percentage
A. AS APPROVED BY THE SENATE COMMITTEE ON FINANCE			
0 to $3,000	$1,169	–$773	–66.1
$3,000 to $5,000	3,320	–1,007	–30.3
$5,000 to $7,000	5,591	–948	–17.0
$7,000 to $10,000	11,792	–1,291	–10.9
$10,000 to $15,000	18,494	–1,907	–10.3
$15,000 to $20,000	9,184	–789	–8.6
$20,000 to $50,000	13,988	–1,013	–7.2
$50,000 to $100,000	6,659	–318	–4.8
$100,000 and over	7,686	+203	+2.6
Total	77,884	–7,843	–10.1
B. AS PASSED BY THE HOUSE REPRESENTATIVES			
0 to $3,000	$1,169	–$775	–66.3
$3,000 to $5,000	3,320	–1,049	–31.6
$5,000 to $7,000	5,591	–996	–17.8
$7,000 to $10,000	11,792	–1,349	–11.4
$10,000 to $15,000	18,494	–1,932	–10.4
$15,000 to $20,000	9,184	–775	–8.4
$20,000 to $50,000	13,988	–976	–7.0
$50,000 to $100,000	6,659	–365	–5.5
$100,000 and over	7,686	+324	+4.2
Total	77,884	–7,893	–10.1

[1] Exclusive of tax surcharge.

Table 4 shows the source of the tax relief under the committee amendments and under the House bill for each income level combined with the impact of the reform revenue-raising provisions. This table indicates, for example, that most of the income tax relief for those in the lowest income bracket, as might be expected, is attributable to the low-income allowance, together with elimination of the phaseout of this provision in 1971 and 1972. For those in the $3,000 to $7,000 class, the primary relief occurs as a result of the elimination of the phaseout of the low-income allowance and the rate reduction. In the $7,000 to $10,000 class, the elimination of the phaseout, the increase in the standard deduction and the rate reduction are the important factors accounting for the reduction. For the $10,000 to $15,000 class, where the largest dollar reduction occurs, the most significant factors accounting for relief are the rate reduction and the increase in the standard deduction.

TABLE 4.—TAX RELIEF PROVISIONS UNDER H.R. 13270 AFFECTING INDIVIDUALS AND TOTAL FOR ALL REFORM AND RELIEF PROVISIONS AFFECTING INDIVIDUALS, WHEN FULLY EFFECTIVE, BY ADJUSTED GROSS INCOME CLASS, 1969 LEVELS

A. AS APPROVED BY THE SENATE COMMITTEE ON FINANCE

Adjusted gross income class	Reform provisions	Relief provisions: Low income allowance	Elimination of phaseout	15 percent, $2,000 standard deduction	General rate reduction	Tax treatment of single persons	Total relief provisions	Total, all provisions
				(millions)				
0 to $3,000	+$8	−$552	−$202		−$27		−$781	−$773
$3,000 to $5,000	−6	−72	−788		−141		−1,001	−1,007
$5,000 to $7,000	−4	−1	−594		−329	−$20	−944	−948
$7,000 to $10,000	−5		−335	−$228	−663	−60	−1,286	−1,291
$10,000 to $15,000	+15		−83	−789	−975	−75	−1,922	−1,907
$15,000 to $20,000	+17		−16	−231	−496	−63	−806	−789
$20,000 to $50,000	+94		−8	−117	−806	−176	−1,107	−1,013
$50,000 to $100,000	+146		−1	−7	−420	−36	−464	−318
$100,000 and over	+860			−1	−641	−15	−657	+203
Total	+1,125	−625	−2,027	−1,373	−4,498	−445	−8,968	−7,843

B. AS PASSED BY THE HOUSE OF REPRESENTATIVES

Adjusted gross income class	Reform provisions	Relief provisions: Low income allowance	Elimination of phaseout	15-percent $2,000 standard deduction	General rate reduction	Maximum tax on earned income	Intermediate tax treatment	Total relief provisions	Total, all provisions
					(millions)				
0 to $3,000	+$16	−$522	−$202		−$27		−$10	−$791	−$775
$3,000 to $5,000	−3	−72	−788		−141		−45	−1,046	−1,049
$5,000 to $7,000	+3	−1	−594		−329		−75	−999	−996
$7,000 to $10,000	+7		−335	−$228	−663		−130	−1,356	−1,349
$10,000 to $15,000	+26		−83	−789	−975		−111	−1,958	−1,932
$15,000 to $20,000	+23		−16	−231	−496		−55	−798	−775
$20,000 to $50,000	+90		−8	−117	−806		−135	−1,066	−976
$50,000 to $100,000	+137		−1	−7	−420	−$20	−54	−502	−365
$100,000 and over	+1,081			−1	−641	−80	−35	−757	+324
Total	+1,380	−625	−2,027	−1,373	−4,498	−100	−650	−9,273	−7,893

For income levels above $15,000, the standard deduction increase gradually becomes less significant, and the rate reductions account for most of the reductions thereafter.

Table 5 presents for both the committee amendments and the House bill, a breakdown of the impact of the reform provisions by income levels. As is shown by this table, by far the greater portion of the reform provisions have their effect at income levels of $100,000 and over. This accounts for the net increase in tax liability for this income group, while net reductions are provided for the other groups.

TABLE 5.—TAX REFORM PROVISIONS UNDER H.R. 13270 AFFECTING INDIVIDUALS, FULL-YEAR EFFECT—BY ADJUSTED GROSS INCOME CLASS

A. AS APPROVED BY THE SENATE COMMITTEE ON FINANCE

Adjusted gross income class	Change alternative tax on long-term gains [1]	Capital loss limitation	Pension plan provision	Life estates provision	Averaging at 120 percent	Charitable deductions	Reduce percentage depletion	Accumulation trusts	Moving expenses	Foreign income	Farm losses	Real estate	Tax free dividends	Tax on preference income	Total
							millions								
0 to $3,000		+$5	(2)		(2)		(2)	(2)	−$1			(2)	(2)	+$4	+$8
$3,000 to $5,000		+3	+$1		(2)		+$1	+$1	−12			(2)	(2)	(2)	−6
$5,000 to $7,000		+5	+2		(2)		+1	+1	−14	(2)		(2)	+$1	(2)	−4
$7,000 to $10,000		+9	+2		(2)		+1	+1	−26	+$1		+$5	+2	(2)	−5
$10,000 to $15,000		+15	+7		−$5		+2	+5	−32	+3		+10	+3	+7	+15
$15,000 to $20,000		+8	+5		−20		+2	+6	−11	+10		+10	+3	+4	+17
$20,000 to $50,000	+$1	+16	+13	(2)	−45		+8	+30	−12	+10		+45	+17	+11	+94
$50,000 to $100,000	+10	+4	+8	+$5	−30		+5	+32	−2	+1	+$5	+50	+19	+39	+146
$100,000 and over	+319	(2)	+17	+5	−10	+$20	+10	+54	(2)	(2)	+20	+135	+35	+255	+860
Total	+330	+65	+55	+10	−110	+20	+30	+130	−110	+25	+25	+255	+80	+320	+1,125

B. AS PASSED BY THE HOUSE OF REPRESENTATIVES

Adjusted gross income class	Eliminate alternative tax rate on long-term gains [1]	6- to 12-month gains included at 100 percent [1]	Capital loss limitation	Pension plan provision	Life estates provision	Averaging including capital gains and 120 percent	Deferred compensation	Charitable deductions	Interest deduction	Reduce percentage depletion	Accumulation trusts	Moving expenses	Farm losses	Real estate	Tax-free dividends	Limit on tax preferences	Allocation	Total
								millions										
0 to $3,000		+$1	+$5	(2)		(2)	(2)			+$1	(2)	−$1		(2)	(2)	+$10	(2)	+$16
$3,000 to $5,000		+2	+3	+$1		(2)	(2)			+1	(2)	−11		(2)	(2)	+1	(2)	−3
$5,000 to $7,000		+2	+5	+2		(2)	(2)			+2	+$1	−13		(2)	+$1	+3	(2)	+3
$7,000 to $10,000		+5	+9	+3		(2)	(2)			+2	+1	−23		+$5	+2	+3	(2)	+7
$10,000 to $15,000		+10	+15	+9		−$5	(2)			+5	+3	−29		+10	+3	+3	+$2	+26
$15,000 to $20,000		+10	+8	+6		−30	(2)			+5	+3	−10		+10	+3	+15	+3	+23
$20,000 to $50,000	+$1	+35	+16	+17	(2)	−110	(2)			+19	+16	−11		+45	+17	+10	+35	+90
$50,000 to $100,000	+11	+30	+4	+10	+$5	−105	+$5			+13	+17	−2	+$5	+50	+19	+10	+65	+137
$100,000 and over	+348	+55	(2)	+22	+5	−50	+20	+$20	+$20	+22	+29	(2)	+20	+140	+35	+30	+365	+1,081
Total	+360	+150	+65	+70	+10	−300	+25	+20	+20	+70	+70	−100	+25	+260	+80	+85	+470	+1,380

[1] Assumes ½ of effect as compared with no change in realization. [2] Less than $500,000.

TABLE 6.—REVENUE ESTIMATES, TAX REFORM UNDER H.R. 13270, CALENDAR YEAR LIABILITY [1]

[In millions of dollars]

Provision	As approved by the Senate Committee on Finance					As passed by the House of Representatives				
	1970	1971	1972	1974	Long run	1970	1971	1972	1974	Long run
Corporate capital gains	140	175	175	175	175	175	175	175	175	175
Foundations	40	45	45	50	55	65	70	75	85	100
Unrelated business income	5	5	5	5	20	5	5	5	5	20
Contributions	5	10	20	20	20	5	10	20	20	20
Farm losses	25	25	25	25	25	([2])	5	10	10	25
Moving expenses	−110	−110	−110	−110	−110	−100	−100	−100	−100	−100
Railroad amortization [3]	−125	−115	−160	−185	−105	([2])	−5	−[4] 15	−[4] 60	−[4] 85
Amortization of pollution facilities [3 5]	−15	−40	−70	−115	−120	−40	−130	−230	−380	−400
Corporate mergers, etc	([2])	([2])	([2])	([2])	([2])	10	20	25	40	70
Multiple corporations	30	70	120	235	235	[4] 45	[4] 75	[4] 105	[4] 175	235
Accumulation trusts	10	25	35	60	130	50	70	70	70	70
Income averaging	−110	−110	−110	−110	−110	−300	−300	−300	−300	−300
Deferred compensation:										
Restricted stock	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])
Other deferred compensation						([2])	([2])	5	10	25
Stock dividends	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])
Subchapter S	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])
Tax-free dividends				80	80				80	80
Financial institutions:										
Commercial banks:										
Reserves	225	150	125	100	100	250	250	250	250	250
Capital gains	([2])	5	5	10	50	50	50	50	50	50
Mutual thrift reserves:										
Savings and loan associations	10	20	30	40	40	10	25	35	60	125
Mutual savings banks	20	25	30	35	35	([2])	5	10	15	35
Tax-exempt interest						([2])	([2])	([2])	([2])	([2])
Individual capital gains:										
Capital loss provisions	50	50	55	60	65	50	50	55	60	65
6 months–1 year holding period [6]						100	150	150	150	150
Pension plans	([2])	5	10	20	55	([2])	5	10	25	70
Casualty loss	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])
Sale of papers	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])
Life estates	10	10	10	10	10	10	10	10	10	10
Franchises	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])	([2])
Alternative rate provision [6]	200	265	330	330	330	360	360	360	360	360
Natural resources:										
Production payment	100	110	125	150	200	100	110	125	150	200
Percentage depletion	155	155	155	155	155	400	400	400	400	400
Foreign depletion						25	10	([2])	([2])	([2])

Foreign income:										
Loss carryover						35	35	35	35	35
Restriction on mineral credits						30	30	30	30	30
Reduced exclusion	25	25	25	25	25					
Individual interest deduction						20	20	20	20	20
Regulated utilities [3,5]	60	140	185	260	310	60	140	185	260	310
Cooperatives						(2)	(2)	(2)	(2)	(2)
Limit on tax preferences						40	50	60	70	85
Allocation						205	420	425	440	470
Tax on preference income	650	655	665	690	700					
Real estate:										
Used property [3,5]	15	40	65	150	250	15	40	65	150	250
New nonhousing [3,5]	(2)	60	170	435	960	(2)	60	170	435	960
Capital gain, recapture	(2)	10	20	40	100	5	15	25	50	125
Rehabilitation [3,5]	−15	−50	−100	−200	−330	−15	−50	−100	−200	−330
Total tax reform	1,400	1,655	1,880	2,440	3,350	[4] 1,665	[4] 2,080	[4] 2,215	[4] 2,650	[4] 3,605
Plus investment credit	2,500	2,990	2,990	3,090	3,300	2,500	3,000	3,000	3,100	3,300
Total	3,900	4,645	4,870	5,530	6,650	[4] 4,165	[4] 5,080	[4] 5,215	[4] 5,750	[4] 6,905

[1] Except as indicated these estimates are all at current levels, the time differences being solely to show the phasein.
[2] Less than $2,500,000.
[3] The figures in the "long run" columns are for 1979.
[4] Revised.
[5] Assumes growth.
[6] Assumes ½ of effect as compared with no change in realization.

Note: Calendar year 1969 estimates, not shown above, are as follows: under the Finance Committee bill and the House bill repeal of the investment credit $900,000,000; under the House bill, corporate capital gains $75,000,000, multiple corporations $20,000,000, accumulation trusts $20,000,000, and individual capital gains $175,000,000.

TABLE 7.—TAXABLE RETURNS UNDER PRESENT LAW NUMBER MADE NONTAXABLE BY RELIEF PROVISIONS AND NUMBER BENEFITING FROM RATE REDUCTION UNDER H.R. 13270[1] BOTH AS APPROVED BY THE SENATE COMMITTEE ON FINANCE AND AS PASSED BY THE HOUSE OF REPRESENTATIVES

[Number of returns in thousands]

Adjusted gross income class	Returns taxable under present law	Returns made nontaxable by low-income allowance and 15 percent $2.000 standard deduction[2]	Returns remaining taxable—benefiting from rate reduction[2]
0 to $3,000	10,053	5,149	4,504
$3,000 to $5,000	9,562	405	9,157
$5,000 to $7,000	9,779	24	9,755
$7,000 to $10000	13,815	8	13,807
$10,000 to $15,000	13,062	4	13,058
$15,000 to $20,000	3,852	2	3,850
$20,000 to $50,000	2,594		2,594
$50,000 to $10,0000	340		340
$100,000 and over	95		95
Total	63,152	5,592	57,560

[1] Provisions effective for tax year 1972 and thereafter.
[2] Revised.

TABLE 8.—TAX BURDEN ON THE SINGLE PERSON UNDER PRESENT LAW [1] AND UNDER H.R. 13270 [2] AS APPROVED BY THE SENATE COMMITTEE ON FINANCE AND AS PASSED BY THE HOUSE OF REPRESENTATIVES (ASSUMES NONBUSINESS DEDUCTIONS OF 10 PERCENT OF INCOME)

A. AS APPROVED BY THE SENATE COMMITTEE ON FINANCE

TAX BURDEN ON SINGLE PERSONS

Adjusted gross income (wages and salaries)	Tax under present law	Tax under H.R. 13270 as approved by Finance Committee	Tax decrease: Amount	Tax decrease: Percentage
$900	0	0	0	0
$1,700	$115	0	$115	100.0
$3,000	329	$180	149	45.3
$3,500	415	258	157	37.8
$4,000	500	344	156	31.2
$5,000	671	524	147	21.9
$7,500	1,168	1,005	163	14.0
$10,000	1,742	1,468	274	15.7
$12,500	2,398	1,977	421	17.6
$15,000	3,154	2,602	552	17.5
$17,500	3,999	3,320	679	17.0
$20,000	4,918	4,098	820	16.7
$25,000	6,982	5,635	1,347	19.3

B. AS PASSED BY THE HOUSE OF REPRESENTATIVES

1. TAX BURDEN ON SINGLE PERSONS UNDER 35 (OTHER THAN WIDOWS AND WIDOWERS)

Adjusted gross income (wages and salaries)	Tax under present law	Tax under H.R. 13270 as passed by House	Tax decrease: Amount	Tax decrease: Percentage
$900	0	0	0	0
$1,700	$115	0	$115	100.0
$3,000	329	$180	149	45.3
$3,500	415	258	157	37.8
$4,000	500	344	156	31.2
$5,000	671	524	147	21.9
$7,500	1,168	1,023	145	12.4
$10,000	1,742	1,507	235	13.5
$12,500	2,398	2,078	320	13.3
$15,000	3,154	2,806	348	11.0
$17,500	3,999	3,683	316	7.9
$20,000	4,918	4,650	268	5.4
$25,000	6,982	6,566	416	6.0

2. TAX BURDEN ON SINGLE PERSONS 35 AND OVER (AND WIDOWS AND WIDOWERS AT ANY AGE)

Adjusted gross income (wages and salaries)	Tax under present law	Tax under H.R. 13270 as passed by House	Tax decrease: Amount	Tax decrease: Percentage
$900	0	0	0	0
$1,700	$115	0	$115	100.0
$3,000	329	$175	154	46.0
$3,500	415	250	165	39.8
$4,000	500	331	169	33.8
$5,000	671	501	170	25.3
$7,500	1,168	957	211	18.1
$10,000	1,742	1,399	343	19.7
$12,500	2,398	1,907	491	20.5
$15,000	3,154	2,532	622	19.7
$17,500	3,999	3,250	749	18.7
$20,000	4,918	4,042	876	17.8
$25,000	6,982	5,643	1,339	19.2

[1] Exclusive of tax surcharge.
[2] Provisions effective for tax year 1972 and thereafter.

TABLE 9.—TAX BURDEN ON THE MARRIED COUPLE WITH NO DEPENDENTS UNDER PRESENT LAW [1] AND UNDER H.R. 13270 [2] AS APPROVED BY THE SENATE COMMITTEE ON FINANCE AND AS PASSED BY THE HOUSE OF REPRESENTATIVES (ASSUMES NONBUSINESS DEDUCTIONS OF 10 PERCENT OF INCOME)

Adjusted gross income (wages and salaries)	Tax under present law	Tax under H.R. 13270 as approved by Finance Committee and passed by House of Representatives	Tax decrease: Amount	Tax decrease: Percentage
$1,600	0	0	0	0
$2,300	$98	0	$98	100.0
$3,000	200	$91	109	54.5
$3,500	275	158	117	42.5
$4,000	354	228	126	35.6
$5,000	501	375	126	25.1
$7,500	915	792	123	13.4
$10,000	1,342	1,174	168	12.5
$12,500	1,831	1,599	232	12.7
$15,000	2,335	2,098	237	10.1
$17,500	2,898	2,669	229	7.9
$20,000	3,484	3,276	208	6.0
$25,000	4,796	4,530	266	5.5

[1] Exclusive of tax surcharge.
[2] Provisions effective for tax year 1972 and thereafter.

TABLE 10.—TAX BURDEN ON THE MARRIED COUPLE WITH TWO DEPENDENTS UNDER PRESENT LAW [1] AND UNDER H.R. 13270 [2] AS APPROVED BY THE SENATE COMMITTEE ON FINANCE AND AS PASSED BY THE HOUSE OF REPRESENTATIVES (ASSUMES NONBUSINESS DEDUCTIONS OF 10 PERCENT OF INCOME)

Adjusted gross income (wages and salaries)	Tax under present law	Tax under H.R. 13270 as approved by Finance Committee and passed by House of Representatives	Tax decrease: Amount	Tax decrease: Percentage
$3,000	0	0	0	0
$3,500	$70	0	$70	100.0
$4,000	140	$65	75	53.6
$5,000	290	200	90	31.0
$7,500	687	576	111	16.2
$10,000	1,114	958	156	14.0
$12,500	1,567	1,347	220	14.0
$15,000	2,062	1,846	216	10.5
$17,500	2,598	2,393	205	7.9
$20,000	3,160	2,968	192	6.1
$25,000	4,412	4,170	242	5.5

[1] Exclusive of tax surcharge.
[2] Provisions effective for tax year 1972 and thereafter.

TABLE 11.—EFFECT OF H.R. 13270 AS APPROVED BY THE SENATE COMMITTEE ON FINANCE AND AS PASSED BY THE HOUSE OF REPRESENTATIVES ON FISCAL YEAR RECEIPTS, 1970 AND 1971

[In billions]

As approved by the Senate Committee on Finance			As passed by the House of Representatives		
Provision	Fiscal year 1970	Fiscal year 1971	Provision	Fiscal year 1970	Fiscal year 1971
Tax reform provisions (+):			Tax reform provisions (+):		
Corporation[1]	+$0.3	+$0.8	Corporation	+$0.4	+$1.0
Individual[2]	+([3])	+.5	Individual	+.3	+.6
Total, tax reform provisions	+.3	+1.3	Total, tax reform provisions	+.7	+1.6
Tax relief provisions (−):			Tax relief provisions (−):		
Individual	[4] −.7	−3.0	Individual	−.7	−3.6
Other provisions (+):			Other provisions (+):		
Repeal of investment credit:			Repeal of investment credit:		
Corporation	+.9	+1.9	Corporation	+.9	+1.9
Individual	+.4	+.6	Individual	+.4	+.6
Total, repeal of investment credit	+1.3	+2.5	Total, repeal of investment credit	+1.3	+2.5
Extension of tax surcharge:			Extension of tax surcharge:		
Corporation	+.3	+.7	Corporation	+.3	+.7
Individual	+1.7	+.4	Individual	+1.7	+.4
Total, surcharge extension	+2.0	+1.1	Total, surcharge extension	+2.0	+1.1
Extension of excise taxes	+.5	+1.1	Extension of excise taxes	+.5	+1.1
Total, other provisions	+3.8	+4.7	Total, other provisions	+3.8	+4.7
Total, all provisions	+3.4	+3.0	Total, all provisions	+3.8	+2.7

[1] Does not reflect the substantial, but immeasurable, increase in tax receipts resulting from the imposition of increased penalties for failure to pay tax and make deposits when due.

[2] Does not reflect the substantial, but immeasurable, increase in tax receipts resulting from the imposition of increased penalties for failure to pay tax and make deposits when due; nor the increase in receipts resulting from the provisions regarding the reporting of medical payments and regarding the limitations on pension plans of professional service corporations, for which data are not available.

[3] Less than $50,000,000.

[4] Does not reflect $200,000,000 reduction in receipts resulting from certification of nontaxability for withholding tax purposes.

IV. GENERAL EXPLANATION

A. TAX TREATMENT OF PRIVATE FOUNDATIONS

(Sec. 101 of the bill and secs. 507 through 509, 4940 through 4948, 6033, 6034, 6104, 6213, 6501, 6511, 6652, 6684, 7422, and 7454 of the code)

1. Limitation on Tax-exempt Life of Foundations (secs. 101(a) and (b) of the bill and secs. 507(b), 508(d)(2), and 4490(b) of the code)

Present law.—The Internal Revenue Code does not at present limit the period of time for which a private foundation or any other exempt organization may continue to be exempt from income tax.

General reasons for change.—Questions have been raised as to whether private foundations should in perpetuity be exempt from income tax, and forever eligible to receive deductible charitable contributions. In part, the problem is that if foundations have a permanent tax-exempt life, their economic power may increase to such an extent that they have an undue influence both on the private economy and on governmental decisions. Also, since income, estate, or gift tax deductions were granted for amounts given to these foundations and the basis for these deductions is that these funds would be used for educational, charitable, religious, etc., purposes, questions have been raised as to why, after some period of time, the donated funds themselves should not actually be so used, rather than merely the income from these funds. (Since the income is itself exempt from taxation in the hands of the foundation, the expenditure of the income only satisfies the obligations associated with the income tax exemption of the foundation and not the obligations associated with the charitable contribution deduction for what is the capital, or corpus, of the foundation.)

The committee concluded that, by the end of 40 years, a private foundation if it is to continue to be tax exempt should have been able to derive sufficient public support to become a public charity, or should have created an appropriate operating foundation function for itself, or should have used its assets directly for the charitable purposes for which it was created.

Explanation of provisions.—To deal with the problems described above, the committee adopted an amendment limiting the period of income tax exemption to 40 years in the case of any private foundation (other than an operating foundation). By the end of the 40-year period unless it is to become taxable, the private foundation either must have distributed all its assets to public charities or must itself have become a public charity.

If the foundation neither makes such a distribution nor so converts itself, it is to be subject to regular income taxation, and still is to remain subject to all the limitations and requirements applicable to private foundations.[1] In such a case the foundation would then be taxed as a corporation or as a trust depending on its status under the general tax laws. No new contributions or bequests to the foundation would be eligible for charitable contribution deductions and gift tax deductions would not be allowed.

For existing foundations, the 40-year period is to begin on January 1, 1970. An organization created in the future or becoming a private foundation in the future is to have 40 years from the time it becomes a private foundation. If a private foundation becomes a public charity or an operating foundation at any time in the future, it is not required to cease operating as an exempt organization at the end of 40 years. However, the 40 years need not be consecutive, but will include all periods after December 31, 1969, during which the organization is a private foundation, other than an operating foundation.

If an existing private foundation becomes a public charity in 1970, as described below in *Change of Status*, this provision is not to apply. In this case if the organization later reverts to private foundation status the 40-year period would begin to run from the time the organization again becomes a private foundation.

In order to prevent avoidance of this limit on the tax-exempt life of nonoperating private foundations the amendment provides that a transfer of assets to another private foundation under a liquidation, merger, etc., as distinguished from a bona fide charitable grant, causes the transferee foundation to be charged with that part of the 40-year period already used by the transferor. Where there is a transfer of the sort that would cause a "tacking on" of part of a 40-year life, the transferee foundation will be treated as acquiring generally the characteristics of the transferor foundation. For example, anyone who was

[1] If the sum of the audit-fee tax and any taxes on unrelated business income exceed the regular income tax in any year, then the total tax will be the sum of the former taxes instead of the regular income tax for that year.

a substantial contributor to the transferor will be treated as a substantial contributor to the transferee. Also, the total tax benefits of the transferor (described below, in *Change of Status*) is to be treated as tax benefits of the transferee. (Where there are several transferees, the amount of the benefits will be apportioned.)

Effective date.—This provision takes effect on January 1, 1970.

2. Audit-fee Tax (sec. 101(b) of the bill and sec. 4940 of the code)

Present law.—Although present law subjects many exempt organizations to taxation on unrelated business income, investment income is specifically exempted from this tax (sec. 512(b)). No amount is paid the Government to cover the cost of examining the finances and activities of the foundation to see that it continues to qualify for exemption.

General reasons for change.—The committee agrees with the House that private foundations should be subject to substantial supervision, of the type appropriate to their receipt of tax benefits under the Internal Revenue Code. It also agrees that the costs of this supervision should not be borne by the general taxpayer, but rather should be imposed upon those exempt organizations whose activities have given rise to much of the need for supervision. Accordingly, the committee agrees that an annual tax should be imposed upon private foundations.

However, the committee believes that it is important to distinguish between this need for a "user charge" and any withdrawal of the income tax exemption of these organizations. It believes that it is appropriate to continue income tax exemption (subject to the 40-year provision described above) for these organizations without any reduction in any manner in this tax-exempt status. Because of this it believes that it is more appropriate to cast this audit fee in the form of a charge measured by the value of the assets to be supervised and examined rather than in the form of a charge on income which some, however inappropriately, might view as a beginning in the removal of income tax exemption.

Accordingly, the committee determined to impose an annual tax as a percentage (subject to a minimum) of the noncharitable assets of the foundation.

The committee views this tax as a supervisory fee and as an indication of the amount of funds needed by the Internal Revenue Service for proper administration of the Internal Revenue Code provisions relating to private foundations and other exempt organizations.

Explanation of provisions.—The committee substituted for the House provision an annual audit-fee tax of one-fifth of 1 percent upon the noncharitable assets of private foundations, but in no event less than $100. This replaces the House provision which would have imposed a tax of 7½ percent on the investment income of such organizations.

The tax base is in general to be the same as the base used for determining the minimum amount such a foundation must distribute currently, as described below in *Distributions of Income.* The base does not include assets used (or held for use) directly in the active conduct of the foundation's charitable activities. In the case of operating foundations (described below) meeting the usual "assets test," substantially more than half of their assets would not be subject to this tax.

Where the assets include all the stock of a corporation performing a functionally related activity (such as Colonial Williamsburg's Lodge and Inn), then the tax base is not to include those underlying assets which, if held by the foundation directly, would be assets used in the active conduct of the foundation's charitable activities. However, any endowment or other noncharitable assets of the subsidiary corporation, to the extent they are reflected in the value of the stock of the subsidiary, would be included in the base for the private foundation's audit-fee tax.

It is contemplated that assets (such as stock in closely held corporations) which might prove difficult to value, would be valued perhaps as infrequently as once every 3 years. For purposes of this tax, in the case of an asset that has not been recently valued, the last previous value used for purposes of determining the minimum payout is to be treated as the value upon which the tax imposed by this section is computed.

Effective date.—This provision applies to taxable years beginning after December 31, 1969.

Revenue effect.—The revenue to be produced by this provision is estimated at $40 million in 1970, rising to about $55 million a year in the long run.

3. Prohibitions on Self-dealing (sec. 101 (b), (a), (c), (f), (g), (h) and (i) of the bill and secs. 4941, 508, 4946, 6213, 6501, 6511, 6684, and 7454 of the code)

Present law.—Present law (sec. 501(c)(3)) imposes upon every organization qualifying as an educational, charitable, relgious, etc., organization the requirement that "no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual * * *."

The 1950 amendments to the exempt organizations provisions (now sec. 503 of the code), set forth specifically a number of prohibited types of self-dealing transactions which apply to what are now called "private foundations". Arm's-length standards are imposed with regard to loans, payments of compensation, preferential availability of services, substantial purchases or sales, and substantial diversions of income or corpus to (or from, as the case may be) creators (of trusts) and substantial donors and their families and controlled corporations.

The sanctions provided are loss of exemption for a minimum of one taxable year, and loss of charitable contributions deductions under certain circumstances.

General reasons for change.—Arm's-length standards have proved to require disproportionately great enforcement efforts, resulting in sporadic and uncertain effectiveness of the provisions. On occasion sanctions are ineffective and tend to discourage the expenditure of enforcement effort. On the other hand, in many cases the sanctions are so great, in comparison to the offense involved, that they cause reluctance in enforcement, especially in view of the element of subjectivity in applying arm's-length standards. Where the Internal Revenue Service does seek to apply sanctions in such circumstances, the same factors encourage extensive litigation and a noticeable reluctance by the courts to uphold severe sanctions.

Therefore, as a practical matter, current law has not preserved the integrity of private foundations, even where the terms of the law apply. Also, the committee has concluded that even arm's-length standards often permit use of a private foundation to improperly benefit those who control the foundation. This is true, for example, where a foundation (1) purchases property from a substantial donor at a fair price, but does so in order to provide funds to the donor who needs access to cash and cannot find a ready buyer; (2) lends money to the donor with adequate security and at a reasonable rate of interest, but at a time when the money market is too tight for the donor to readily find alternate source of funds; or (3) makes commitments to lease property from the donor at a fair rental when the donor needs such advance leases in order to secure financing for construction or acquisition of the property.

To minimize the need to apply subjective arm's-length standards, to avoid the temptation to misuse private foundations for noncharitable purposes, to provide a more rational relationship between sanctions and improper acts, and to make it more practical to properly enforce the law, the committee has determined to generally prohibit self-dealing transactions and to provide a variety and graduation of sanctions, as described below.

The committee's decisions, generally in accord with the House bill, are based on the belief that the highest fiduciary standards require that self-dealing not be engaged in, rather than that arm's-length standards be observed.

Explanation of provisions.—Both the House bill and committee amendments remove private foundations from the present arm's-length self-dealing requirements (sec. 503) and, in place of those limitations, prohibit self-dealing, a comprehensively defined term. They also provide for a graduated series of sanctions against the self-dealer and against a foundation manager who willfully engages in self-dealing. In the case of willful repeated acts or a willful and flagrant act, the Internal Revenue Service can require the foundation either to pay back to the Government the income, estate, and gift tax benefits (with interest) which the foundation and all its substantial contributors had received or can require the foundation to distribute all its assets to a public charity or operate as a public charity itself. Appropriate opportunities for court review are provided. In addition each foundation's charter is required to prohibit the foundation from engaging in self-dealing.

The bill prohibits the following transactions between a private foundation and a disqualified person: (1) sale or exchange, or leasing, of property; (2) lending of money or other extension of credit; (3) furnishing of goods, services, or facilities; (4) payments of compensation or expenses by the foundation to a disqualified person; (5) transfer to or use by or for the benefit of a disqualified person, of the foundation's income or assets; and (6) payments to government officials. The committee added a seventh category to the bill—payment by a private foundation of any of the taxes imposed by the new provisions upon any disqualified person. The addition of this seventh category is not to be taken as narrowing the scope of the fifth category.

A self-dealing transaction may occur even though there has been no transfer of money or property between the foundation and any disqualified person. For example, a "use by, or for the benefit of, a disqualified person of the income or assets of a private foundation" may consist of securities purchases or sales by the foundation in order to manipulate the prices of the securities to the advantage of the disqualified person.

A "disqualified person" for purposes of this provision on self-dealing, as well as the provisions (discussed below) regarding excess business holdings and mandatory payouts, is (1) a substantial contributor, (2) a foundation manager, (3) a person who owns more than 20 percent of a corporation, partnership, trust, or unincorporated enterprise which is itself a substantial contributor, (4) a member of the family of any individual in the first three categories, or (5) a corporation, partnership, trust, or estate as to which all such persons own in the aggregate more than 35 percent. A government official (described below) is a disqualified person for purposes of the self-dealing provisions even if he is otherwise unrelated to the foundation.

The committee's amendments provide that a "substantial contributor" for these purposes is an individual, corporation, or other entity that has contributed in the aggregate more than 2 percent of the total contributions to the foundation up to that time. (Even if this 2-percent test is met, however, the person is not a substantial contributor unless that person's contributions totaled more than $5,000.) Each contribution is taken into account at fair market value at the time it was made. (If a husband and wife together contribute more than 2 percent, then each of them is a substantial contributor.)

In the case of existing foundations, the calculations as to gifts made on or before October 9, 1969, are to be made as though all such gifts were contributed at one time. In the case of gifts made after that date the calculations are to be made as of the close of each taxable year of the foundation. If a person was a substantial contributor as of October 9, 1969, or became one thereafter, he would remain a substantial contributor even though later contributions by others brought his total below the overall 2-percent de minimis level.

The House bill had provided that a substantial contributor is anyone who contributed more than $5,000 in any one year (or who contributed more than anyone else in any one year, even if that was less than $5,000). The committee feared this rule would characterize many persons as substantial contributors when in fact their contributions had no real impact on the foundation.

The committee accepted the House bill's rules as to family and other attribution, with two changes: (1) the term "family" still includes ancestors, lineal descendants, and spouses of the above but the committee decided not to include brothers and sisters (and their descendants and spouses) and (2) it decided that relationship through a partnership should take into account another partner only if the other partner held at least a 20-percent interest in partnership profits.

The committee was especially concerned that the rules be reasonable as to who are substantial contributors and related persons because the foundation will need to keep the records to identify those who are disqualified from dealing with it. The committee concluded that the 2-percent minimum for substantial contributors, the elimination of brother-sister attribution, and the 20-percent minimum for partnerships would make the rules practical and enforceable.

It has been suggested that many of those with whom a foundation "naturally" deals are, or may be, disqualified persons. However, the difficulties that prompted this legislation in many cases arise because foundations "naturally" deal with their donors and their donors' businesses.

If a substantial donor owns an office building, the foundation should look elsewhere for its office space. (Interim rules provided in the case of existing arrangements are discussed below.) A recent issue (May 1969) of the American Bar Association Journal discussing an instance of an attorney purchasing assets at fair market value from an estate he was representing suggests the problems even in "fair market value" self-dealing:

> The Ethics Committee said that it is generally "improper for an attorney to purchase assets from an estate or an executor or personal representative, for whom he is acting as attorney. Any such dealings ordinarily raise an issue as to the attorney's individual interest as opposed to the interest of the estate or personal representative whom he is representing as attorney. While there may be situations in which after a full disclosure of all the facts and with the approval of the court, it might be proper for such purchases to be made * * * in virtually all circumstances of this kind, the lawyer should not subject himself to the temptation of using for his own advantage information which he may have personally or professionally * * *"

A contribution of property is a self-dealing act if the foundation assumes a mortgage on the property or if the foundation takes subject to a mortgage placed on the property by a disqualified person within 10 years before the transfer. A loan or the furnishing of goods, services, or facilities to the foundation is permitted if no interest or other charge is imposed and if the loan proceeds or the goods, services, or facilities are used exclusively for certain exempt purposes. The furnishing of goods, services, or facilities by the foundation is permitted if it is not on a basis more favorable than that available to the general public. Of course, the furnishing by a foundation of office space and similar facilities to its manager for use for the charitable purposes of the foundation (including necessary administrative activities) is not to constitute self-dealing, even if the general public does not normally have access to those offices. Payment by the foundation of compensation and expenses is permitted if the payment is not excessive and if the services are reasonable and necessary for the foundation's exempt purposes. Certain transactions regarding corporate stock are permitted if done on a uniform basis at fair market value.

For purposes of the self-dealing provisions government officials are disqualified persons. A government official is a person who, at the time of the self-dealing act, holds any of the following offices or positions: elective public office in the executive or legislative branch of the U.S. Government; a Presidentially appointed office in the executive or judicial branch of the U.S. Government; a position in any branch of the U.S. Government under civil service schedule C of rule VI or which is paid at least as much as the lowest "supergrade" (GS-16) salary (at present $25,044 per year); a position under the U.S. House of Representatives or the Senate at a salary of at least $15,000 per year; an elective or appointive public office in the executive, legislative, or judicial branch of a State or local government, a U.S. possession, or the District of Columbia, at a salary of at least $15,000 per year; or a position as personal or executive assistant or secretary of any of the foregoing.

However, a government official who is a "special Government employee"—a temporary employee (less than 130 days a year), a part-time U.S. commissioner or magistrate, a part-time local representative of a Member of Congress in the Member's home district, or a Reserve or National Guard officer on active duty for training or involuntarily—is not a government official for these purposes.[2]

Acts that constitute self-dealing for other disqualified persons have been modified in several respects with regard to government officials. Compensation and reimbursement of expenses are prohibited (whether reasonable in amount or not) except that domestic travel expenses may be reimbursed within specified limits. On the other hand certain specified items may be received by a government official: certain nontaxable prizes and awards if the recipients are selected from the general public, nontaxable scholarships and fellowship grants to be used for study at educational institutions, and annuity or other payments under certain stock-bonus, pension, and profit-sharing plans. Also permitted are contributions or gifts (other than of money) to, or services or facilities made available to, a government official, but only if their aggregate value in any one year does not exceed $25, and payments made under the Government employees training program authorized by chapter 41 of title 5, United States Code. These provisions are not to interfere with legitimate activities by private foundations in connection with government officials, while at the same time they minimize the possibility of improper influencing of the attitude or conduct of such policymaking level officials.

If there has been a prohibited act of self-dealing, then a three-level set of sanctions is to be applied. The first level of sanctions is relatively light. This tax is imposed on the self-dealer at a 5-percent rate on the amount involved in the self-dealing for each year (or part thereof) from the date of the self-dealing until the self-dealing is corrected (or the Internal Revenue Service mails a deficiency notice regarding the transaction, if sooner). The amount involved is the greater of the value of what the foundation gave or what it received at the time of the self-dealing (in the case of personal services by other than government officials, it is only the excess compensation).

Where the self-dealing does not involve a transfer, then the amount involved is the amount used by or for the benefit of the self-dealer. The first-level tax is to be imposed automatically, without regard to whether the violation was inadvertent. However, if the self-dealer is a disqualified person only because he is a government official then the tax on self-dealing is imposed only if he knowingly participated in the self-dealing.

Where this first-level tax is imposed, there is also to be a tax of 2½ percent on the foundation manager, but only if the manager knowingly participated in the self-dealing. The tax on the manager may not exceed $10,000. The committee has concluded that, in order to avoid imposing unreasonable burdens upon foundation managers, it is appropriate (1) to apply this sanction to the manager only where the violation is willful and is not due to reasonable cause, and (2) to impose upon the Service the same burden of proof where such a sanction is being considered as is required in cases of civil fraud—that is, proof by clear and convincing evidence. The committee expects that the Commissioner of Internal Revenue will include in his annual report a review of the number of cases in which sanctions are imposed upon foundation managers.

[2] Military officers (other than those described above) who receive Presidential appointments are government officials regardless of the amount of their compensation.

The second level of tax applies if the self-dealing is not "undone" or (if undoing is not possible) the foundation is not made whole or given the benefit of the bargain within 90 days after the mailing of the deficiency notice with respect to the first level of tax. At the second level, the tax on the self-dealer is 200 percent of the amount involved. A second-level tax is also imposed on the foundation manager if he refuses to agree to any part of the correction. This tax is at the rate of 50 percent of the amount involved. Again, this tax on the manager may not exceed $10,000. For purposes of this sanction, the amount involved is the highest fair market value of the property during the period within which the transaction may be undone. This provision is intended to impose all market fluctuation risks upon the self-dealer who refuses to comply and to give the foundation the benefit of the best bargain it could have made at any time during the period.

The second-level sanction, imposed only after a notice of deficiency and adequate opportunity for court review and undoing the self-dealing transaction, is intended to be sufficiently heavy to compel voluntary compliance (at least, after court review). The committee expects application of this sanction to be rare, but where the parties refuse to undo the transaction, it is expected that this sanction will be applied.

A penalty doubling the amount of the first or second level of tax would be imposed in the case of repeated violations, or a willful and flagrant violation.

The 90-day period for the second level of tax provides an opportunity for court review and could also be extended if the Service determines that such extension is reasonable and necessary to correct the self-dealing. For example, extensions would be granted if State officials took appropriate action to correct the self-dealing and preserve the assets for charity. Where the State officials take appropriate action which the Service determines to be sufficient to satisfy the requirements of this section, then the second-level tax is not to be imposed.

A third level of tax applies if there have been willful repeated acts or a flagrant and willful act to which the self-dealing rules apply. This sanction is discussed below in *Change of Status*.

The first- and second-level taxes are treated like income, estate, and gift taxes in the sense that the Internal Revenue Service is required to send deficiency notices to the self-dealer and the foundation manager, who then have 90 days to petition the Tax Court. The usual statute of limitations for assessment applies—3 years unless there is a substantial omission of tax on the return filed by the foundation (6-year statute of limitations) or no return has been filed (assessment at any time).[3] The 90-day period for petitioning the Tax Court and the statute of limitations for assessing and collecting the tax are suspended during any extension by the Service of the time for correcting the self-dealing.

The third-level tax is an income tax. As in the case of fraud, it may be assessed at any time.

Refund suits for first- or second-level taxes may be brought in the Court of Claims or in a district court (but only if there has been no prior court review of the prohibited act). Also, any refund suit will be treated as disposing of all issues relating to any first- or second-

[3] The committee understands that the exempt organization information return will be revised to have one or more questions on it regarding the first- and second-level taxes, sufficient so it will constitute an excise tax return. This procedure is followed because the first- and second-level taxes are excise taxes, under subtitle D, and the statute of limitations provisions regarding such taxes depend upon the filing of a return of subtitle D taxes.

level tax arising out of that prohibited act. An opportunity is provided for one court review of a self-dealing transaction, but no more than one review.

To limit opportunities for improper self-dealing, and to facilitate appropriate action by State officials to supervise private foundations, the bill requires, as a condition of tax exemption, that the foundation's governing instrument prohibit it from engaging in self-dealing. Existing organizations are given until 1972 to modify their governing instruments or longer if it is impossible to conform their governing instruments by then.

Effective date.—The self-dealing provisions take effect on January 1, 1970; however, they do not apply to (1) transactions pursuant to the terms of certain securities (such as callable preferred stock) acquired by the foundation before October 9, 1969, (2) dispositions, at fair market value or better, of excess business holdings held by the foundation on October 9, 1969,[4] and (3) use of property in which the foundation and a disqualified person have joint interests, but only if both parties acquired their interests before October 9, 1969.

In addition, the committee amendments make provision for certain transitional rules designed to permit the continuance of leases, loans, and sharing arrangements which were in effect on October 9, 1969. These may continue for not more than 10 years, but only where they are not disadvantageous to the foundation and continue to avoid disadvantage to the foundation at all times during the 10-year period.

If the parties choose to modify an existing arrangement as to matters that are not substantial, such modifications will be permitted only if the modified arrangement is at least as advantageous to the foundation as the arrangement had been immediately before the modification. In addition, property acquired in the future under a will executed by October 9, 1969,[5] or under the mandatory provisions of a trust or document transferring property to a trust if such provisions were irrevocable on October 9, 1969, and at all times thereafter until the foundation's acquisition, is to be treated under the committee's amendments as though such property had been acquired by the foundation before October 9, 1969, for purposes of the special rule permitting fair market value dispositions of existing excess business holdings. Also, where sales are permitted under the House bill, in the case of required divestitures, the committee also would permit exchanges and other dispositions.

These provisions have been added by the committee to permit the orderly elimination of existing arrangements. The committee does not wish to permit such arrangements or sales for the future, but believes limited exceptions are desirable so that an appropriate transition can be made.

4. Distributions of Income (sec. 101(a) of the bill and section 4942 of the code)

Present law.—Present law (sec. 504(a)(1) of the code) provides that a private foundation loses its exemption if its aggregate accumulated income is "unreasonable in amount or duration in order to carry out the charitable, educational, or other purpose or function constituting the basis for exemption under section 501(a) of an organization described in section 501(c)(3)."

[4] Such a sale is not disqualified by being made in such a way that both the selling foundation and the purchasing disqualified person avoid the payment of brokerage commissions.

[5] If a later codicil to such a will changes the rights of the foundation, the codicil causes the will to be treated as having been executed on the date of the codicil.

General reasons for change.—Under present law, if a private foundation invests in assets that produce no current income, then it need make no distributions for charitable purposes. As a result, while the donor may receive substantial tax benefits from his contribution currently, charity may receive absolutely no current benefit. In other cases, even though income is produced by the assets contributed to charitable organizations, no current distribution is required until the accumulations become "unreasonable." Although a number of court cases have begun to set guidelines as to the circumstances under which an accumulation becomes unreasonable, in many cases the determination is essentially subjective. Moreover, as is the case with self-dealing, it frequently happens that the only available sanction (loss of exempt status) either is largely ineffective or else is unduly harsh.

The committee has concluded that substantial improvement in the present situation can be achieved by providing sanctions if income is not distributed currently. A graduation of sanctions, designed to produce current benefits to charity, is provided.

Explanation of provisions.—The bill provides that to avoid tax private foundations must distribute all income currently (but not less than 5 percent of investment assets), and imposes graduated sanctions in the event of failure to distribute.[6] Provisions are made to extend the time within which the distributions must be made in certain circumstances and to allow a carryforward of "excess" distributions.

Under the bill, to avoid tax a private foundation must distribute currently all of its net income (including the excess of exempt interest over the expenses of earning the interest), other than net long-term capital gains. Expenses of earning the income, including depreciation and depletion where appropriate, are deductible in computing the net income subject to this rule.[7]

To prevent avoidance of the requirement for distribution of income by investments in growth stock or nonproductive land, the bill requires a foundation to pay out at least a specified percentage of its average noncharitable assets. The minimum payout is set at 5 percent for taxable years beginning in 1970 in the case of new organizations (this rule is modified for existing organizations, as described below) and the Secretary of the Treasury is authorized to adjust this rate (prospectively) from time to time based upon changes in money rates and investment yields using as his standard the 5-percent rate, given rates and yields for 1969. This does not mean that a foundation may not make low-yield investments if it so desires. However, if it does so it is likely that the foundation will find that it either periodically must sell shares to enable it to meet the payout requirements or that it must distribute shares to public charities in partial satisfaction of those requirements.

The committee's amendments make it clear that the audit-fee tax (described above) and the unrelated business income tax reduce the amount the foundation must pay out to meet the minimum distribution requirements, and reasonable administrative expenses of operating the foundation constitute qualifying distributions.

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[6] The bill also repeals sec. 504 since with the change referred to above it is no longer needed.

[7] Operating foundations (described below in *Private Operating Foundation Definition*) are subject to different requirements regarding expenditures and the use of their assets; they are not required to meet the distribution requirements provided in this section. However, as indicated below, they normally are proper recipients of distributions which qualify under this section.

Assets used directly for the active conduct of the foundation's exempt purposes are not included in the base upon which the 5-percent payout applies. The value of assets which can be easily ascertained is to be determined by averaging the monthly values of the assets. Other assets will be valued as frequently as is appropriate. A committee amendment allows foundations to make deficiency distributions (along the lines of the deficiency dividend procedure at present followed by personal holding companies) to the extent that failure to distribute the proper amount is because of a failure to properly value the foundation's assets, if the failure was not willful and was due to reasonable cause.

Under the bill, payouts must be made in the year in which the money is received or in the next year, except to the extent that the foundation is permitted to set aside funds for periods of up to 5 years for certain major projects. Any such set-asides must be approved in advance by the Internal Revenue Service. The Service may extend the 5-year period if good cause is shown. This exception is intended to apply to those situations where relatively long term grants must be made in order to assure continuity of particular charitable projects or where the grants are made as part of a matching grant program. This exception will not apply unless it is established that the amount set aside will in fact be paid out for the specific project within 5 years. It is expected that such set-asides will be approved where the State attorney general undertakes appropriate action to insure that the funds will be timely and charitably distributed.[8]

A further exception is provided where a private foundation spends more than the minimum required payout in a given year. Such excess expenditures may be applied against required payouts in the next 5 years. A committee amendment makes it clear that the level of distributions in years before the first taxable year beginning after December 31, 1969, are not to be taken into account for purposes of applying this 5-year carryover rule.

For the purpose of this payout requirement, qualifying distributions include distributions to "public charities" and private operating foundations, direct expenditures for charitable purposes, and expenditures for assets to be used for charitable purposes. Contributions to other private foundations are not forbidden, but (except in the case of a contribution to a private operating foundation or a "12-month pass-through," described below) they do not count as qualifying distributions for the minimum payout. The committee expects the Internal Revenue Service to publish lists of operating foundations that may be used by foundation managers desiring to make qualifying distributions.

A committee amendment makes it clear that where a student loan or any other capital expenditure, which previously had been a qualifying distribution, is later repaid or liquidated, the repayment (sale, or other liquidation) is to be considered to be income in the year of the repayment (or other transaction) to the extent of the prior qualifying distribution. This will not interfere with proper charitable use of such loans (and purchases) but at the same time will prevent use of such loans (and purchases) to evade the minimum payout rules.

8 The rule described more fully below, that of including in income for this purpose any receipt on the liquidation of a student loan or sale of a charitable asset, is also to apply to the set-asides described here. That is, where an amount is set aside and as a result is treated as a qualifying distribution, if it is later determined that the amount is not needed for the purpose for which it was set aside, then the amount remaining is taken back into income.

The bill provides that a foundation may not make a qualifying distribution to a controlled organization. (This is modified to some extent by the 12-month pass-through provision described below.) An organization is "controlled" by a granting foundation and disqualified persons if all such persons may, by aggregating their votes or positions of authority, require the donee organization to make a distribution, or prevent the donee organization from making a distribution. For this purpose the organization controlled by a private foundation need not be another private foundation; it may be any type of exempt or nonexempt organization including a school, hospital, operating foundation, or social welfare organization.

The committee amendment makes a significant exception to the distribution rules by qualifying a distribution to another private foundation or to a controlled 501(c)(3) organization if the funds are spent or used for charitable purposes by the end of the taxable year after the year of receipt by the donee organization. To qualify, however. the donee organization must spend or use the funds, in addition to sufficient other distributions which meet its regular minimum payout requirements.

This amendment permits an additional year's delay in the payment of funds into the stream of charitable expenditures but it was believed that this was necessary to provide adequate flexibility in operations for private foundations. To limit any further delay, however, the amendment provides the donee organization is not to be permitted to pass such a grant through to another private nonoperating foundation or to a controlled organization.

These distribution requirements do not apply to a private operating foundation (except the one-year pass-through rule in the case of a controlled operating foundation) and, as indicated above, a private operating foundation is a qualified recipient of such distributions. The requirements that an organization must meet in order to qualify for such treatment are discussed below in *Private Operating Foundation Definition*.

Failure to comply with the minimum payout requirements is to result in sanctions against the foundation. The first level of sanction is a tax of 15 percent of the amount that should have been, but was not, paid out. This tax is imposed for each year until the private foundation is notified of its obligation or until the foundation itself corrects its earlier failure by making the necessary payouts. As indicated above, under the committee's amendments, to the extent the failure to meet the minimum payout requirement results from an incorrect valuation of the foundation's relevant assets and this incorrect valuation is not willful but is due to reasonable cause, then the foundation will be able to avoid even the first-level tax by promptly making deficiency distributions (along the lines of the deficiency divident procedure presently available to personal holding companies).

As is the case with self-dealing, within 90 days after notification by the Internal Revenue Service the foundation must correct its failure to make the appropriate charitable distributions. This 90-day period may be extended as described above, under *Prohibitions on Self-Dealing*. If the necessary distributions are not made within the appropriate period, the second level of sanctions is imposed—a tax of 100 percent of the amount required to be paid out.

Provisions regarding penalties for repeated or flagrant violations, court review, the third level of sanctions, and the governing instrument are the same as those described under *Prohibitions on Self-Dealing*.

Effective date.—The payout requirements apply to taxable years beginning after December 31, 1969. However, in the case of an existing organization, the minimum payout (the 5-percent rule described above) is not to apply until taxable years beginning after December 31, 1971.

To afford existing organizations a greater opportunity to revise their investment and payout practices, the committee added a phase-in period with regard to the 5-percent rule. For calendar-year organizations, this would mean that in 1972 the minimum payout would be 3½ percent, 4 percent in 1973, 4½ percent in 1974, and the basic 5-percent rule would apply thereafter. If the 5-percent figure is decreased by the Secretary of the Treasury before 1975, then the phase-in period percentages are to be proportionately adjusted.

The minimum payout amount is not to apply to the extent it cannot be met because the foundation's existing governing instrument requires income to be accumulated, but only if this requirement in the governing instrument would not have caused the organization to lose its exempt status under present law. Also, the minimum payout requirement will not apply to the extent that the foundation's existing governing instrument forbids invasion of corpus to meet the payout requirement. These exemptions will continue after 1971 only to the extent that it is impossible to reform the foundation's governing instrument to permit it to comply with the general rule.

The committee also recognized that obligations presently outstanding may have been undertaken in good faith by foundations in the past. In order to permit such obligations to be carried out the committee has provided that a grant within the next 5 years to a noncontrolled private foundation (even if it is not an operating foundation) under a written commitment which was binding on October 9, 1969, and at all times thereafter, is to be treated as a grant to an operating foundation, if the grant is made in order to carry out the charitable, educational, or other purpose or function constituting the basis for such organization's exemption. Moreover, the expenditure responsibility requirements (described below in *Limitations as to Activities of Foundations*) are not to apply to such a grant. The donee private foundation, however, would be subject to all the limitations imposed by the bill upon private foundations.

5. Stock Ownership Limitation (sec. 101(b) of the bill and sec. 4943 of the code)

Present law.—Present law does not deal directly with foundation ownership of business interests, although some cases have held that business involvement can become so great as to result in loss of exempt status.

General reasons for change.—The use of foundations to maintain control of businesses appears to be increasing. It is unclear under present law at what point such noncharitable purposes become sufficiently great to disqualify the foundation from exempt status. Moreover, the loss of exempt status is a harsh sanction for having such holdings.

The Treasury Department in its 1965 study of private foundations included the following examples of where business, and not charitable, purposes appeared to predominate in foundation activities:

Example 1.—The A foundation holds controlling interests in 26 separate corporations, 18 of which operate going businesses. One of the businesses is a large and aggressively competitive metropolitan newspaper, with assets reported at a book value of approximately $10,500,000 at the end of 1962 and with gross receipts of more than $17 million for that year. Another of the corporations operates the largest radio broadcasting station in the State. A third, sold to a national concern as of the beginning of 1965, carried on a life insurance business whose total assets had a reported book value of more than $20 million at the end of 1962. Among the other businesses controlled by the foundation are a lumber company, several banks, three large hotels, a garage, and a variety of office buildings. Concentrated largely in one city, these properties present an economic empire of substantial power and influence.

Example 2.—The B foundation controls 45 business corporations. Fifteen of the corporations are clothing manufacturers; seven conduct real estate businesses; six operate retail stores; one owns and manages a hotel; others carry on printing, hardware, and jewelry businesses.

Example 3.—The C foundation has acquired the operating assets of 18 different businesses, including dairies, foundries, a lumber mill, and a window manufacturing establishment. At the present time it owns the properties of seven of these businesses. Its practice has been to lease its commercial assets by short-term arrangements under which its rent consists of a share of the profits of the leased enterprise. By means of frequent reports and inspections, it maintains close check upon its lessees' operations.

This is not simply a phenomenon of the past. Recently, a major newspaper carried the following advertisement:

"Tax exempt organization will purchase companies earning $300,000 pre tax at high earnings multiple. Immediate action."

Those who wish to use a foundation's stock holdings to acquire or retain business control in some cases are relatively unconcerned about producing income to be used by the foundation for charitable purposes. In fact, they may become so interested in making a success of the business, or in meeting competition, that most of their attention and interest is devoted to this with the result that what is supposed to be their function, that of carrying on charitable, educational, etc. activities is neglected. Even when the foundation attains a degree of independence from its major donor, there is a temptation for the foundation's managers to divert their interest to the maintenance and improvement of the business and away from their charitable duties. Where the charitable ownership predominates, the business may be run in a way which unfairly competes with other businesses whose owners must pay taxes on the income that they derive from the businesses. To deal with these problems, the committee has concluded it is desirable to limit the extent to which a business may be controlled by a private foundation.

Explanation of provisions.—The bill limits to 20 percent the combined ownership of a corporation's voting stock which may be held by future foundations and all disqualified persons. If someone else can be shown to have control of the business, the 20-percent limit is raised to 35 percent. Excess holdings acquired by gift or bequest in the future generally must be disposed of within 5 years. Exceptions are provided in the case of related businesses, special rules apply to existing holdings, and a series of graduated sanctions are provided.

Under the bill, a foundation and all disqualified persons together may not hold more than 20 percent of the voting stock of a corporation. If more is held, then the foundation must reduce its holdings to the extent necessary to bring the combined holdings down to 20 percent.[9]

If more than 20 percent of the combined voting stock is held by the foundation and disqualified persons, then the foundation must dispose of its nonvoting stock as well as its voting stock. The 20-percent limit, however, may be increased to 35 percent if it can be demonstrated that an unrelated party has effective control over the corporation.

The committee has used only voting stock in this case to determine whether divestiture should be required, because it does not appear probable that a foundation's holding of nonvoting stock could be effectively used to preserve control if the disqualified persons hold little or no voting stock. On the other hand, if the disqualified persons or such persons and the foundation combined hold more than 20 percent of the voting stock, then the foundation's holding of nonvoting stock might effectively remove from outsiders any practical opportunity to gain control. Under those circumstances the foundation's retention of even the nonvoting stock might well be the result of decisions to place the interest of disqualified persons ahead of charitable interests.[10]

The committee has added an amendment which prohibits a foundation from voting more than half of the voting stock it purchases. This limitation will not apply to stock acquired by gift or bequest nor to stock held by private foundations on October 9, 1969.

The above rules have been stated in terms of corporate stocks but corresponding limitations apply to partnerships and other entities. A private foundation is not permitted to own a business as a sole proprietorship.

As indicated above, in the case of excess holdings resulting from gifts or bequests made in the future, 5 years are allowed to dispose of the excess holdings. However, no time is allowed to dispose of an excess resulting from a purchase by the foundation or a disqualified person.

In computing the amount of stock considered as held by the foundation and related parties, stock held by corporations, partnerships, estates, and trusts under the House bill is deemed to be held proportionately by the shareholders, partners, and beneficiaries of those entities. While the committee retained this as its basic rule, it modified the rule to provide that the foundation's interest in a trust is not to be attributed to the foundation currently. To do so in some cases would result in the foundation being required to divest itself of stock it does not hold.

[9] A *de minimis* rule permits the foundation to retain not more than 2 percent of the voting stock, notwithstanding this limitation, but the holdings of related private foundations are aggregated for the purpose of this exception. This is done to avoid the use of "multiple foundations" to convert the *de minimis* rule into a method of evading the basic rule of this provision.

[10] Compare the different rules described below regarding present business holdings, where 50-percent ownership is permitted.

The committee concluded that the divestiture rules applicable to nonexempt trusts with charitable interests,[11] and attribution to holders of other interests in the trust are sufficient so that the use of trusts will not significantly delay divestitures. In any event, the foundation is to be treated as having acquired the stock in a trust when its remainder interest becomes a current possessory interest.

The committee also provided that stock in a passive holding company is not to be considered a business holding, even if the holding company is controlled by the foundation. Instead, the foundation is to be treated as owning its proportionate share of the underlying assets of the holding company. The committee also made it clear that passive investments generally are not to be considered business holdings. For example, the holding of a bond issue is not a business holding, nor is the holding of stock of a company which itself derives income in the nature of a royalty to be treated as a business holding. Where a corporation purchases a product under a contract with the manufacturer, resells it under contracts at a uniform markup in price, and does not physically handle the product, the income derived from that markup is in the nature of a royalty and meets the definition of passive income. On the other hand, income from individually negotiated sales such as those made by a broker, would not meet the passive income definition, even if the broker did not physically handle the goods.

Business holdings do not include "program-related investments" (such as investments in small businesses in central cities or in corporations to assist in neighborhood renovation) which are part of the foundation's charitable program, where the making of a profit for the foundation is not one of the significant purposes for holding these investments.

An exception to the limitations on the holding of business interests under both versions of the bill is provided in the case of a business which is related under the provisions dealing with taxes on unrelated business income. Another exception is provided, even where the business, although unrelated to the direct activities of the foundation, "is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which is related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exempt purposes of the organization."

These exceptions are intended to make it clear that certain types of business activities may continue to be held by the foundation notwithstanding the general rule. For example, the Inn and Lodge at Colonial Williamsburg are separately incorporated taxable entities, but are owned by the foundation for the convenience of the general public visiting Williamsburg. Also, many museums maintain cafeterias and snack bars for the convenience of the public visiting the museums. Although advertising in a foundation's journal may be an unrelated trade or business under existing regulations and this bill (described below in sec. 121), it will come under the second of these exceptions if the foundation's journal is related to the foundation's exempt purposes. Such business activities would not have to be disposed of under these provisions. If a private foundation is exempt under the present

[11] The nonexempt trusts are subject to the divestiture requirements when the interests of charity in the trust amount to 60 percent or more.

statutory provisions as a charitable scientific organization, then its tax-paying subsidiaries may continue to be wholly owned if they serve to translate the scientific achievements of the foundation into human progress by such means as demonstrating the feasibility of new scientific discoveries, or aiding in the economic or technical development of geographical areas by bringing to the public innovative products and processes which might not otherwise reach the public.

The rules described above requiring divestiture where business holdings exceed 20 percent (or 35 percent in some cases) under the committee amendments do not apply to existing holdings. In this regard the committee substantially revised the House bill.[12] In the case of existing stock holdings, under the committee amendments the foundation and all disqualified persons together may hold up to 50 percent of a company's stock. No further divestiture (and generally no interim 2-year and 5-year divestitures) is required. This percentage is to be determined both on the basis of the voting power of the stock outstanding and (separately) on the basis of the value of the stock outstanding.[13]

However, the conversion features of convertible bonds and other securities are to be ignored for the voting test until the conversion occurs. The conversion features will, of course, be considered in determining the value of the outstanding stock.

These rules for existing holdings generally are to apply to stock acquired before October 9, 1969. However, they also are to apply in the case of stock acquired after that date if it is acquired pursuant to the terms of a trust which was irrevocable on that date or pursuant to the terms of a will executed before that date.[14]

The time available for divestiture of excess business holdings obtained from a trust or estate begins to run from the time the foundation actually received the stock from the trust or estate. The Service has been upheld, in situations where final distributions of estates and trusts were being unduly delayed, in treating the estates and trusts as having actually distributed all their assets when the distributions would have been made but for the undue delay.

Where the combined holdings on October 9, 1969, exceeded 75 percent, an additional 5 years (making a total of 15 years) is to be available for disposition of excess holdings. This modification was provided by the committee because the practical difficulties in disposing of a company's equity are apt to be substantial where the foundation owns the bulk of the company's stock.

These rules replaces the special effective date provision in section 101(k)(4) and (5) of the House bill.

If existing holdings are below the 50-percent limitation but above the 20-percent limitation applicable for the future, then the holdings need not be decreased to 20 percent but on the other hand may not be increased. In this regard, the percentages of stock held on October 9,

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[12] Under the House bill, existing holdings would be treated essentially the same as later acquisitions except that more time (10 years) would be available for reaching the 20 (or 35) percent limits and interim divestitures would also be required.

[13] Nonvoting stock may be of little significance in determining control when the voting percentage is limited to 20 percent, but is almost certain to be of significance, even in closely held companies, when the limit on voting stock is raised to 50 percent.

[14] If stock would pass to the foundation under a will that meets the test referred to above but before that time actually passes under a trust which would have met that test but for the fact that the trust was revocable (even though it was not in fact revoked), then the stock is for the business holding requirement to be treated as having been acquired by the foundation under the will.

1969, are to become the applicable limitations for the foundation and all disqualified persons where their holdings are above 20 percent but below 50 percent. If an existing foundation reduces its present percentage holdings of a corporation, it may not again increase these holdings except that if they fall below the levels applicable for future holdings (namely, the 20 percent or 35 percent levels) [15] they may be increased to these levels.

Limited exceptions to the self-dealing rules in the case of current excess business holdings were discussed above in *Prohibitions on Self-Dealing*. The committee amendments (see section on reasonable accumulations by corporations) also provide that redemptions of stock by a closely held corporation from a foundation will not result in imposition of the accumulated earnings tax with respect to that corporation if the stock is redeemed in order to comply with the divestiture requirements. Also, a redemption for such purposes will not give rise to dividend treatment to the foundation (for purposes of the income distribution requirement) or to other shareholders of the corporation. Where an exchange is permitted as an exception from the self-dealing rules, then the property received in such an exchange after the effective date of these provisions would not be treated as having been purchased. (As indicated above the 5 years available for divestitures of future-acquired property is not available for purchases.) For example, if a substantial donor to a foundation leaves a number of business holdings jointly to his widow and his foundation, the widow and the foundation then exchange their half-interests so that each owns 100 percent of half the businesses, and this exchange does not violate the self-dealing rules because it conforms to the special exception to those rules provided by the committee's amendments in the case of existing holdings, then the business holdings are not treated as having been acquired by the foundation by purchase. These provisions, too, are available only in the case of October 9, 1969, excess holdings (including those excess holdings under existing wills and existing irrevocable trusts).

The committee concluded that the less stringent divestiture rules described above were desirable in existing situations in order not to disrupt a foundation's investment plans and also because to do otherwise would materially affect the worth of the business being divested. As to the future, 5 years should be sufficient where the excess holdings develop after knowledge of the new rules.

In both versions of the bill a series of sanctions applies to the foundation if it does not meet the divestiture requirements. The first-level sanction is a tax of 5 percent each year on the value of the greatest amount of excess holdings at any time during the year.

The foundation will ordinarily have had at least 5 years (10 or 15 in the case of existing holdings) to dispose of its excess business interests before this sanction applies.

After the imposition of the 5 percent tax the same 90-day correction period (with possible extensions) also is available here as in the case of self-dealing. If the excess holdings are not disposed of during the correction period, then a second-level sanction—a tax of 200 percent of the value of the excess holdings—is imposed upon the foundation.

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[15] If a future acquisition by a disqualified person results in a requirement of divestiture by the foundation, then the time allowed for divestiture begins to run from the date the total holdings exceeded the permitted percentages.

Provisions regarding penalties for repeated or flagrant violations, court review, the third level of sanctions, and reformation of the governing instrument are the same as in the case of self-dealing.

Effective date.—The limitations on business ownership apply to taxable years beginning after December 31, 1969. An exception is made for existing holdings which are required by the governing instrument to be retained but only to the extent that it is impossible to reform the governing instrument or be excused from its limitations forbidding compliance with these requirements.

The committee also decided to make the divestiture provisions inapplicable in two types of cases. The first is where the following conditions exist:

(1) The foundation on October 9, 1969, owned 95 percent or more of the voting stock of the corporation.

(2) The stock was acquired by the foundation solely by gift, devise, or bequest before December 31, 1956.

(3) No member of the governing body of the foundation is a substantial contributor or members of his family at any time on or after December 31, 1956.

(4) The business of the corporation was, on October 9, 1969, and continues to be of substantially the same character as the enterprise which was conducted at the time of the last gift of the stock by the donor.

(5) The corporation in 3 of the last 5 years and in every year in the future distributes to its shareholders at least 40 percent of its income after taxes and the foundation distributes or uses substantially all of its income for its tax-exempt purposes.

(6) The corporation does not in the future acquire any stock in another business enterprise which would represent excess business holdings. A business holding owned by a private foundation through a holding company, all the voting stock of which was owned by the foundation on all the critical dates, is treated as being owned directly by the foundation for these purposes.

The second type of case where the committee decided to make the stock divestitute requirements inapplicable is in the case of foundations incorporated before January 1, 1951, where substantially all of the assets of the foundation on October 9, 1969, consisted of more than 90 percent of the stock of an incorporated business enterprise which is licensed and regulated, the sales and contracts of which are regulated, and the professional representatives of which are licensed, by State regulatory agencies in at least 10 States and the foundation received its stock solely by gift, devise, or bequest. Stock of a company placed in trust with provision for the charitable remainder to go to the foundation upon the death of the life beneficiary also is treated as coming under this provision if the foundation holds on October 9, 1969, without regard to this trust, more than 20 percent of the stock of the enterprise. Such a foundation also must not acquire in the future any stock in another business enterprise which would represent excess business holdings and must distribute or use substantially all of its income for its tax-exempt purposes.

In both of these types of cases, the business holdings referred to are only those actually owned by the foundation on the relevant dates, except in the case of ownership through a holding company in the first type of case (where the foundation must have actually owned 95 percent of the holding company's stock on the relevant dates) and the limited case of the trust holding described in the second type of case.

The committee also decided that where a corporation (together with its subsidiaries) owns more than 10 percent of the land area of any major political subdivision in the United States (a county or incorporated city with a population of more than 100,000) and a foundation has excess holdings in such a corporation, then if the foundation and the disqualified persons together own more than 75 percent of the corporation's stock, 10 percent of the excess holdings must be disposed of within two years, 25 percent within five years, 50 percent within ten years, and the remainder by the 15th year, if the sanctions are not to apply.

In taking this action the committee is aware that there may be some foundations whose governing or controlling instruments make it difficult to comply with these provisions, such as where a trust instrument would require the foundation to dispose of all of its stockholdings should a sale of any of its stock ever be required. In such a case, this amendment would require total divestiture within the two-year period, unless the foundation's governing or controlling instrument could be amended to comply with this provision of the bill.

6. Limitations on Use of Assets (sec. 101(b) of the bill and sec. 4944 of the code)

Present law.—Present law (sec. 504(a)(3)) provides that a private foundation is to lose its exemption if its accumulated income is invested in such a manner as to jeopardize the carrying out of its exempt purposes (under sec. 501(c)(3)). No similar specific limitations apply to investment of principal.

General reasons for change.—The grant of current tax benefits to donors and exempt organizations usually is justified on the basis that charity will benefit from the gifts. However, if the organization's assets are used in a way which jeopardizes their use for the organization's exempt purpose this result is not obtained. Present law recognizes this concept in the case of income, but not in the case of an organization's principal.

Under present law a private foundation manager may invest the assets (other than accumulated income) in warrants, commodity futures, and options, or may purchase on margin or otherwise risk the corpus of the foundation without being subject to sanction. (In one case a court held that the consistent practice of making such investments constituted operation of the foundation for a substantial non-exempt purpose and would result in loss of tax exemption.)

The committee agrees with the House that the same reasoning should apply to investments which jeopardize the foundation's corpus. Here, as in other sections, the committee also concluded that limited sanctions were preferable to the loss of exemption.

Explanation of provisions.—The bill imposes upon all assets of a foundation the same limitations presently applicable to accumulated income. As a result, under this provision, a foundation cannot invest its corpus in a manner which would jeopardize the carrying out of its exempt purposes.[16]

A committee amendment, however, makes it clear that a program-related investment—such as low-interest or interest-free loans to needy students, high risk investments in low-income housing, and loans to small businesses where commercial sources of funds are unavailable—is not to be considered as an investment which might jeopardize the foundation's carrying out of its exempt purposes (since such an investment is classified as a charitable expenditure). To qualify as a program-related investment, the investment must be primarily for charitable purposes and not have as one of its significant purposes that of deriving a profit for the foundation.

A committee amendment also makes it clear that the determination of whether investments jeopardize the carrying out of the foundation's charitable purposes is to be made as of the time of the investment, in accordance with a "prudent trustee" approach, and not subsequently, on the basis of hindsight after a loss occurs.

The sanction provided by the House bill where investments are made in a manner which jeopardizes the carrying out of the organization's exempt function is a tax of 100 percent of the amount improperly invested. The committee amendments provide, instead, an initial sanction on private foundations of 5 percent of the amount involved and an initial tax on the foundation manager, where he knowingly jeopardizes the carrying out of the foundation's exempt purposes of 5 percent (up to a maximum of $5,000). They also provide, where the jeopardy situation is not corrected, a second level sanction or tax of 25 percent on the foundation and a 5-percent tax on the foundation manager who refuses to take action to correct the situation (in the case of the foundation manager, this sanction may not exceed $10,000).

The committee amendments further provide that before the second stage sanctions are imposed the State Attorney General is to be given an opportunity to intervene in the case to exercise whatever powers he has to correct the situation. Where the Treasury Department finds the situation is corrected, the second level sanctions are not to be imposed.

Provisions regarding penalties for repeated or flagrant violations, third-level sanctions, court review, governing instrument provisions, and the procedures to be followed in imposing sanctions upon foundation managers are essentially the same as those which apply in the case of self-dealing.

Effective date.—This provision takes effect on January 1, 1970.

7. Limitations as to Activities of Foundations (sec. 101(b) of the bill and sec. 4945 of the code)

Present law.—Present law requires that no substantial part of the activities of a private foundation may consist of carrying on propaganda or otherwise attempting to influence legislation. It further provides that no such organization may "participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office." The corresponding charitable contributions deduction provision prohibits substantial propaganda activities but does not deal specifically with the

[16] These provisions replace section 504 of present law, the violation of which results in loss of tax exemption.

electioneering activities. Another provision prohibits the use of accumulated income to a substantial degree for nonexempt purposes.

Although the present provisions permit some degree of influencing legislation by the organization involved, it provides that no degree of support for an individual's candidacy for public office is permitted.

In general the language of the statute relating to deductions (sec. 170) is essentially the same as that of the exempting provision. Although the deduction provision also prohibits substantial activities in the influencing of legislation, it does not at present specifically include any prohibition on participation in political campaigns on behalf of any candidate for public office.

Present law (sec. 504(a)(2)) also provides that a private foundation loses its exemption if its accumulated income is used to a substantial degree for purposes other than its exempt purposes.

General reasons for change.—As is the case with the other limitations described above, the only sanctions available at present with respect to political activity by a foundation are loss of exemption and denial of charitable contribution deduction status. Moreover, a large organization, merely because of the substantiality test, may engage without consequence in more lobbying than a small organization. In addition, a well-endowed organization may engage in lobbying and, if it loses its exempt educational or charitable status, may avoid tax on its investment income by becoming exempt under another provision of the law. Moreover, the standards as to the permissible level of activities under present law are so vague as to encourage subjective application of the sanction.

Another problem arises from the fact that the absolute prohibition upon involvement in political campaigns on behalf of any candidate for public office frequently results in the alternatives of unreasonably severe punishment or unreasonably light punishment. As a practical matter, many organizations often find ways of making clear their views regarding opposing political candidates without fear that their exempt status will be revoked. Also, there is no prohibition against taking sides as to referendum issues. The latter activity is regarded as influencing legislation, but, as indicated above, that is specifically permitted to a limited extent.

In recent years, private foundations have become increasingly active in political and legislative activities. In several instances called to the committee's attention, funds were spent in ways clearly designed to favor certain candidates. In some cases, this was done by financing registration campaigns in limited geographical areas. In other cases contributions were made to organizations that then used the money to publicize the views, personalities, and activities of certain candidates. It also appears that officials of some foundations exercise little or no control over the organizations receiving the funds from the foundation.

Congressional policy regarding carrying on this type of political activity with tax-exempt or tax-deductible funds appears to be clear in view of the language of present law (set forth above), the nondeductibility of contributions to political parties, and the provisions of present law which forbid the use of bad debts, advertising expenses, and other devices to secure deductions for what are, as a practical matter, political contributions (secs. 162(e), 271, and 276).

It also was called to the committee's attention that existing law does not effectively limit the extent to which foundations can use their money for "educational" grants to enable people to take vacations abroad, to have paid interludes between jobs, and to subsidize the preparation of materials furthering specific political viewpoints.

The committee has concluded that more effective limitations must be placed on the extent to which tax-deductible and tax-exempt funds can be dispensed by private persons and that these limitations must involve more effective sanctions. Accordingly, the committee has determined that a tax should be imposed upon expenditures by private foundations for activities that should not be carried on by exempt organizations (such as lobbying, electioneering, and "grass roots" campaigning). The committee also believes that granting foundations should take substantial responsibility for the proper use of the funds they give away.

In general, the committee's decisions reflect the concept that private foundations are stewards of public trusts and their assets are no longer in the same status as the assets of individuals who may dispose of their own money in any lawful way they see fit.

Explanation of provisions.—The bill provides that private foundations are to be forbidden to spend money for lobbying, electioneering (including voter registration drives), grants to individuals (unless there are assurances that the grants are made on an objective basis), grants to other organizations (other than public charities) unless the granting foundation accepts certain responsibilities as to the use of the funds by the donee organization, and for any purpose not coming within their exempt purpose. Any improper expenditure will be subject to tax.

One of the provisions contained in the bill applies specifically to expenses incurred in connection with grass roots campaigns or other attempts to urge or encourage the public to contact members of a legislative body for the purpose of proposing, supporting, or opposing legislation. This prohibition is substantially similar to the provision of present law (sec. 162(e)), which prohibits business deductions for grass roots lobbying activities. Another provision in the bill precludes direct attempts to persuade members of legislative bodies or governmental employees to take particular positions on specific legislative issues. It does not extend to discussions of broad policy problems and issues with such members or employees. In both of these areas the committee was in general agreement with the House bill but concluded that certain amendments were necessary.

The House bill's prohibition on propagandizing or otherwise attempting to influence legislation was modified to conform more closely to the existing regulatory language because it was believed that too much uncertainty had resulted from the House's otherwise useful attempt to describe the limitations of existing law. Essentially, this provision retains the present law provision but removes the "substantiality" test in determining whether a private foundation has made a taxable expenditure in this area.[17] Thus, under the committee amendments, section 4945(e) does not prevent discussion and comment upon policy problems, social or economic issues, and other broad issues where such activities would be considered educational under existing law. The committee's amendment also makes it clear that the expertise of a private foundation is not denied to lawmakers when the lawmakers

[17] The substantiality test remains when the question is as to retention of exempt status.

or other appropriate persons have made written requests for such advice or technical assistance.

The prohibition on propaganda or otherwise attempting to influ nce legislation does permit making available the results of nonpartisan analysis, study, or research. The grass roots provision is not to be treated as having been violated merely because a matter that was the subject of such a study might be expected to be dealt with ultimately by government. Current problems to which this rule would apply include environmental pollution and population growth. Also, a private foundation may appear before, or communicate with, any legislative body regarding possible decisions which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to the foundation. However, his latter exception does not extend to grass roots campaigns on such subjects.

The committee also decided that a noncommercial educational broadcasting (TV or radio) station's adherence to Federal Communications Commission regulations and the "fairness doctrine" (requiring balanced, fair, and objective presentations of issues, and forbidding editorializing) means that such station has not violated the lobbying provision.[18]

The "balance" requirement could be achieved under the bill (as under broadcasting law) in a series of broadcasts even though any single broadcast might not present a completely balanced view of an issue. A private foundation could make grants, or use its money, for such purposes, provided that each grant or a series met these tests.

The prohibition on electioneering is expanded by the House bill to include efforts to influence the outcome of referenda as well as campaigns by individuals for public office. The committee agrees with that decision but has added an amendment limiting the electioneering provisions to expenditures for the purpose of influencing the outcome of any *specific* election. It was concerned that otherwise it might be argued that almost any statement, or study, or general educational activity could at a future date become an issue in an election, depending upon the views of the candidates at that time.

The House bill would have provided that voter registration drives would be permitted where conducted on a nonpartisan basis by broadly supported organizations active in at least five States, provided that contributions to the operating foundations carrying on such activity are not geographically limited as to use. The committee decided to delete the portion of the bill which would permit private foundation funds to be used for voter registration. The committee believes that it is impossible to give assurances in all cases that voter registration drives would be conducted in a way that does not influence the outcome of public elections. In fact, the usual motivation of those who conduct such drives is to influence the outcome of public elections.

The House bill also imposes sanctions upon the making of grants to individuals by private foundations unless the grantees are chosen in open competition or on some other objective and nondiscriminatory basis, in accordance with procedures approved in advance by the Inter-

[18] The committee was informed that many such stations are publicly supported, through community chest drives or otherwise, and many others are agencies of local governments. However, some may be private foundations. It is thought that most if not all of those that are private foundations qualify as operating foundations.

nal Revenue Service. This approval procedure does not contemplate specific approval of particular grant programs but instead one-time approval of a system of standards, procedures, and follow-up designed to achieve the intended degree of objectivity. Where the grants take the form of scholarships there will normally be available the relatively independent supervision of schools and colleges. Prizes or awards that qualify under existing law (sec. 74(b)) for exclusion from income also may be made if the recipient is selected from the general public. Otherwise, the bill requires that any grant by a private foundation be directed toward the production of a specific product (a book, paper, or other study, or a scientific development or useful process), the achievement of a specific objective, or the improvement or enhancement of a literary, artistic, musical, scientific, or other similar capacity, talent, or skill.

The committee added "teaching" to this list of skills. The scholarships, prizes, and other individual grants that a private foundation may make must meet the standards described at the beginning of the preceding paragraph.[19] It is expected that procedures will be promulgated in the near future in accordance with recommendations by a committee that the Commissioner of Internal Revenue has already appointed for this purpose.

A grant, but not a contract for services, is limited by this provision.

A private foundation also is forbidden under the bill to make grants to organizations other than "public charities" unless the granting-foundation assumes "expenditure responsibility." Under this requirement, the granting foundation must make reasonable efforts and establish adequate procedures to see that the funds are spent for the purposes of the grant, obtain full and complete reports as to how the funds are spent, and make full and detailed reports to the Internal Revenue Service regarding such expenditures. This expenditure responsibility under the committee amendments is not to be interpreted as making the granting foundation an insurer of the activity of the organization to which it makes a grant, so long as it uses reasonable efforts and establishes adequate procedures so that the funds will be used for proper charitable purposes. In effect, "prudent man" standards are required in such cases. One way of obtaining this assurance is to obtain independent audits from the donee organization as to the use of the funds in question.

These special requirements apply to foundation grants to (1) other private foundations (operating or non-operating), (2) organizations exempt from tax under provisions of the Code other than section 501(c)(3), and (3) organizations which are not exempt from tax. With the minor exception of organizations testing for public safety, the "expenditure responsibility" requirements do not apply to grants to section 501(c)(3) organizations which are not themselves private foundations. Hence, for example, a foundation making a grant to an educational institution or a publicly supported charity need not require or make the reports prescribed by this provision. Furthermore, as under existing law, where a foundation makes a grant to such an organization in good faith for purposes proper for the granting foundation, the subsequent use of the funds by the recipient institution

[19] Even if it qualifies under these standards, any individual grant also must be tested by the standards described above in *Prohibitions on Self-Dealing*.

is the responsibility of that institution alone, and does not produce tax consequences (under this section) for the grantor or its managers.

It is contemplated that a foundation will be required to specify the purposes of any grant clearly in the terms of the grant itself. The terms of the grant should, also, state plainly the limitations upon the recipient's use of the grant. After the grant is made, the granting foundation must take reasonable steps (a) to secure reports from the grantee on its use of the funds, and (b) to report to the Internal Revenue Service the amount and purposes of the grant, the identity of the grantee, and the data which the grantor obtains on the grantee's use of the funds. The Internal Revenue Service is expected to provide an appropriate schedule or attachment for the annual information return, so that all reports which a grant-making foundation must make to the Internal Revenue Service for 1 year can be consolidated in the foundation's information return for that year. If the grantor discovers a misapplication of the funds by the grantee, it would normally be required to withhold any further payments to the grantee (to the extent that it is legally able to do so) until the misapplication has been corrected, or adequate assurance provided that it will not occur again. Where a grantor foundation adheres to these rules, and a misuse occurs which it has no reasonable means of correcting, it will be deemed to have discharged all responsibilities under this section by reporting the default to the Internal Revenue Service.

The committee concluded that the "expenditure responsibility" requirement of the bill, as amended, properly accommodates the needs for both flexibility and responsibility.

Although present law requires exempt organizations to be operated "exclusively" for the specified charitable purposes, the courts have held that this precludes noncharitable purposes only if they are substantial. The committee does not seek to disturb that interpretation insofar as it relates to determining loss of, or qualification for, exemption. However, all private foundation expenditures for purposes other than those listed in section 501(c)(3) are to be subjected to the sanctions of this provision.[20]

Under the House bill there is one sanction in the case of expenditures for activities under this category. It is a tax equal to 100 percent of the amount improperly spent plus a tax on the foundation manager who knowingly made the improper expenditure of 50 percent of that amount. The committee amendments provide an initial sanction of 10 percent of the amount improperly spent (plus a tax of 2½ percent up to a maximum of $5,000 on any foundation manager who knowingly made the improper expenditure). The heavier sanction would apply later only if the foundation refused to correct the earlier improper action to the extent possible. The heavier sanction on the manager would apply only if he refused to agree to part or all of the correction; that sanction—50 percent of the taxable expenditure—is not to exceed $10,000.

Provisions regarding penalties for repeated or flagrant violations, third-level sanctions, court review, and governing instrument provisions, are essentially the same as those applying to self-dealing.

Effective date.—This provision takes effect on January 1, 1970.

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[20] Section 504, which prohibits the use of accumulated income to a substantial degree for non-501(c)(3) purposes, is repealed.

8. Disclosure and Publicity Requirements (secs. 101(d) and (e) of the bill and secs. 6033, 6034, 6104, and 6652 of the code)

Present law.—Under present law an exempt organization must file annual information returns describing its gross income, expenses, disbursements for its exempt purposes, accumulations, balance sheet, and the total amount of contributions and gifts received by it during the year. This requirement applies only to exempt organizations (under section 501(a)) other than religious organizations and certain of their affiliates, schools and colleges, publicly supported charitable organizations, certain fraternal beneficiary societies, and federally-owned congressionally chartered exempt corporations. These information returns are in addition to the unrelated business income returns required to be filed in certain cases.

No specific sanctions are provided for failure to file an exempt organization information return. However, certain criminal provisions could be applied in extreme cases.

Existing law also provides that the information required to be furnished on exempt organization information returns is open to the public.

General reasons for change.—The present information return requirements are essentially the same as those provided by the 1950 amendments to the charitable organization provisions of the code. The primary purpose of these requirements is to provide the Internal Revenue Service with the information needed to enforce the tax laws. The House and the Finance Committee concluded that experience of the past two decades indicates that more information is needed on a more current basis for more organizations and that this information should be made more readily available to the public, including State officials.

Explanation of provisions.—The bill makes several changes in the present provisions. It requires that information returns are to be filed by additional exempt organizations, that additional information is to be supplied on the returns, that $10 per day is to be paid if the returns are not timely filed, and that the information is to be furnished to appropriate State officials.

The House bill provided that every exempt organization, whether or not a private foundation, must file an annual information return unless the Treasury Department determines that this is unnecessary for efficient tax administration. The committee provided two exceptions to this provision. First, it exempted churches, their integrated auxiliary organizations, and conventions and associations of churches from the requirement of filing this annual information return.[21]

Among the auxiliary organizations to which this exemption applies are the mission societies and the church's religious schools, youth groups, and men's and women's organizations, and interchurch organizations of local units qualifying as local auxiliaries. The committee also exempted from the requirement of filing this annual information return any organization that normally has gross receipts of $5,000 or less where the organization is of a type not required to file an information return under present law. In addition to these two exempt categories, the Treasury Department may exempt other types of organizations from the filing requirements if it concludes that the

[21] Where the church or its auxiliary organization, etc., is engaged in an unrelated business, however, it would still be required to file an unrelated business income tax return.

information is not of significant value. Administrative exceptions may permit groups of affiliated organizations (such as, religous organizations, or chapters, lodges, etc., of national organizations) to file the equivalent of consolidated returns.

A second change in present law made by the House bill required that there be shown on each information return the names and addresses of all substantial contributors, directors, trustees, and other management officials and of highly compensated employees. Compensation and other payments to managers and highly compensated employees also must be shown. The committee is in accord with these changes except that it decided not to require that the names and addresses of substantial contributors be disclosed to the public in the case of exempt organizations other than private foundations (such organizations would, however, be required to disclose these names to the Internal Revenue Service). The committee made this modification because some donors prefer to give anonymously. To require public disclosure in these cases might prevent the gifts.

A third change in present law made by both the House bill and the committee's amendments provides that the failure to file a timely exempt organization information return (unless reasonable cause is shown) is to result in a sanction being imposed on the organization of $10 per day up to a maximum of $5,000 as to any one return. The same sanction is to apply also to a trust that fails to timely file the special information return required as to its deductible charitable contributions.

Failure to file after a reasonable demand by the Internal Revenue Service (unless reasonable cause is shown) is to result in an additional sanction of $10 a day up to a maximum of $5,000 as to any one return. This penalty is imposed on the exempt organization official or employee who fails to file the information return.

The fourth change made by the House bill and the committee amendments directs the Internal Revenue Service to notify State officials of (a) any refusal by the Service to recognize the exempt status of a 501(c)(3) organization previously exempt or applying for recognition of its exemption, (b) any violation by an organization of the requirements of its exemption, and (c) any mailing of a notice of deficiency regarding any of the new taxes imposed by this bill with respect to private foundations. In addition, the Service is to make available information about the items previously referred to that are relevant to any determination under State law.

Effective date.—These provisions apply to taxable years beginning after December 31, 1969. The publicity provisions, including the requirement of notifying State officials, take effect January 1, 1970.

9. Change of Status (sec. 101(a) of the bill and secs. 507, 508, and 509 (b) and (c) of the code)

Present law.—Under present law, an organization is exempt if it meets the requirements of the code, whether or not it has obtained an "exemption certificate" from the Internal Revenue Service.

If an organization does not continue to meet the requirements for exemption, if it commits certain specifically prohibited acts (sec. 503), or if it deals in certain prohibited ways with its accumulated earnings (sec. 504), it loses its exempt status. This loss of exempt status may relate back to the time the organization first violated the code's requirements. However, if the violation occurred after the contributions had been made to the organization, no deductions are disallowed to such contributors. Also, the organization's income tax exemption is not disturbed for years before the organization's first violation.

General reasons for change.—The House and the committee believe that the Internal Revenue Service has been handicapped in evaluating and administering existing laws by the lack of information with respect to many existing organizations.

In addition, they are concerned that in many cases under existing law the loss of exempt status will impose only a light burden on many existing foundations. This is true in those circumstances, for example, where the foundation has already received sufficient charitable contributions to provide its endowment and where the foundation could retain its exemption as to its current income by qualifying for exemption under an exemption category other than section 501(c)(3).

Explanation of provisions.—The bill provides that new exempt organizations must notify the Internal Revenue Service that they are applying for recognition of their section 501(c)(3) exempt status. New and existing organizations also must notify the Service if they claim to be other than private foundations. Exceptions to these rules are to be made in the cases of churches, schools, and other classes of organizations where the Treasury determines full compliance is not necessary to efficient administration. If an organization wishes to avoid the limitations imposed upon private foundations, or if an organization persistently violates these limitations, however, it must repay all the tax benefits that it and its substantial contributors have received.

An organization organized after October 9, 1969, is not to be treated as exempt under section 501(c)(3) unless it has notified the Internal Revenue Service that it is applying for recognition of its exempt status. As under present law, the nature of the organization itself—not the determination of the Service—will control in determining whether the organization is exempt. However, unlike present law, an organization is not to be exempt under section 501(c)(3) if it fails to make its existence and claimed status known.

A similar requirement is to be applied with regard to an organization's status as a private foundation, except that (1) existing section 501(c)(3) organizations, as well as new ones, are required to notify the Service if they consider themselves to be "public charities" and (2) failure to make this notification is to result in a presumption that the organization is a private foundation. This notice is not to be required by the Internal Revenue Service, however, until at least 90 days after the regulations on this point become final.

The House bill provides that the Treasury Department may exempt from either or both of these notification requirements:

(1) churches (or conventions or associations of churches);

(2) schools and colleges; and

(3) any other class of organization where the Treasury determines that full compliance with these provisions is not necessary to efficient administration.

The committee concluded that churches, their integrated auxiliaries, and conventions or associations of churches, whether or not the Treasury acts, should not be required to apply for recognition of their exempt status in order to be exempt from tax nor should they be required to file with the Internal Revenue Service to avoid classification as private foundations. The committee also decided to exclude from these requirements any educational or public charitable organizations whose gross receipts normally are $5,000 or less. As under the House bill, the Treasury Department still will be able to exercise its discretion in exempting other classes of organizations where this is consistent with efficient administration.

The committee agrees with the House that foundations should not receive substantial and continuing tax benefits in exchange for the promise of use of the assets involved for educational, charitable, religious, etc., purposes but avoid the carrying out of these responsibilities. Accordingly, the bill provides that an organization which was a private foundation for its last taxable year ending before October 9, 1969, may not change its status unless it repays to the government the aggregate tax benefits (with interest) which have resulted from its exempt status. A committee amendment permits such an organization to change its status to a public charity by the end of its first taxable year beginning afer December 31, 1969, without becoming liable for this tax.[22] The Treasury Department may also assess this tax in any case where the private foundation has willfully engaged in flagrant or repeated acts (or failures to act) giving rise to tax liability under the other provisions relating to private foundations.

The tax benefits to be repaid in such a case are all of the increases in income, estate, and gift taxes which would have been imposed upon the organization and all substantial contributors [23] if the organization had been liable for income taxes and if its contributors had not received deductions for contributions to the organization. If the foundation is a trust, then the foundation's own income tax benefit is the amount by which its income taxes were reduced because it was permitted to deduct charitable contributions in excess of 20 percent of its taxable income. For purposes of computing the amount of the aggregate tax benefits, all benefits available to the private foundation for taxable years beginning after December 31, 1912, and all tax benefits on contributions made to the foundation after February 28, 1913, are included. In addition, interest on all such benefits is to be added to the amount of the benefits computed, in the case of each benefit, from the first date on which the added tax would have been due if the benefit had not been available.

The amount of this tax is not to exceed the value of the net assets of the foundation determined either as of the first day on which action is taken by the foundation culminating in its loss of exempt status (under sec. 501(c)(3)) or as of the day on which it ceases to be such an organization, whichever is higher.

If a private foundation is required to pay this tax or volunteers to pay this tax to change its status, the Internal Revenue Service may then abate any part of the tax which has not been paid if (1) the foundation distributes all of its net assets to public charities, or (2) itself has operated as an organization which is not a private foundation for at least five years. A committee amendment provides that where a private foundation (which has not willfully and repeatedly or flagrantly violated these provisions) volunteers to change its status by acting in

[22] This tax may be abated, however, as described below.

[23] See discussion above, in *Prohibitions on Self-Dealing*, for definition of "substantial contributor."

all respects as a public charity for at least five consecutive years the foundation is to be classified as a public charity *during* the five-year period. In order to facilitate administration of this provision, the foundation must notify the service of its intentions before the start of the five years. Should the organization fail to act as a public charity during that period, it would lose its status as of that time as a public charity. At that time, its private foundation status would be applied as if it had never achieved status as a public charity for purposes of the change of status rules, which thus would apply from its original inception if it engages in willful and flagrant or willful repeated violations.

In the case of a distribution to other public charities, abatement of the tax is permitted only if the recipient organizations have been public charities for at least five consecutive years.

The exercise of discretion with respect to abatement of the tax will depend upon the extent to which effective assurance can be given that the assets and organizational structure dedicated to charity will in fact be used for charity. It is expected that effective assurances are most apt to be available in those States where there is vigorous enforcement of strong State laws by the State attorney general or other appropriate official. In order to encourage and facilitate effective State involvement, the bill contains as an additional condition of exemption for private foundations, a requirement that the governing instrument require current distributions of income (sec. 4942) and prohibit self-dealing (sec. 4941), retention of excess business holdings (sec. 4943), speculative investments (sec. 4944), and taxable expenditures (sec. 4945). Existing private foundations are given time to modify their governing instruments. The committee intends and expects that this requirement will add to the enforcement tools available to State officials charged with supervision of charitable organizations.

Effective date.—These provisions generally take effect on January 1, 1970, but sections 508 (a), (b), and (c) take effect on October 9, 1969.

10. Definition of Private Foundation (secs. 101 (a) and (b) of the bill and secs. 509 and 4948 of the code)

Present law.—"Private foundation", a term not found in present law, is often used to describe an organization contributions to which may be deducted only up to 20 percent of an individual donor's adjusted gross income. Contributions to other permissible charitable donees may be deducted up to 30 percent of the donor's income. These latter organizations at present are (1) churches, (2) schools, (3) hospitals, (4) fund-raisers for schools, (5) States and subdivisions, and (6) publicly supported charities.

General reasons for change.—In general, the problems that gave rise to the statutory provisions of the bill discussed above appear to be especially prevalent in the case of some organizations presently in the 20-percent group. However, it appears that certain other organizations presently in the 20-percent category generally do not give rise to the problems which have led to the restrictions and limitations described above.

Explanation of provisions.—The bill provides that private foundations subject to the provisions described above (self-dealing, business holdings, accumulations, etc.) are organizations described in section 501(c)(3) *other than:*

(1) organizations, contributions to which may be deducted to the extent of 30 percent (50 percent under the bill) of an individual's income (for list of six categories of organizations, see *present law*, above);

(2) certain other types of broadly, publicly supported organizations (described below);

(3) organizations organized and operated exclusively for the benefit of one or more organizations described in (1) or (2) above which are controlled by one or more of these organizations or are operated in connection with one of these organizations and are not controlled by disqualified persons (other than foundation managers, disqualified only as such, and organizations described in (1) or (2) above); and

(4) organizations which are organized and operated exclusively for testing for public safety.

The first and fourth categories are essentially the same as in present law. The second category provides that private foundation treatment is not to apply in the case of an organization (including a membership organization) which normally receives no more than one-third of its support in each year from gross investment income, if more than one-third of its support comes from the public (in the form of gifts, grants, contributions, membership fees, and gross receipts from admissions and other related activities) not taking into account amounts received from disqualified persons. This requirement is designed to insure that the organization is responsive to the general public. The remainder of the organization's support may come from substantial contributors and other disqualified persons.

Any gross investment income distributed by a charitable trust which is not exempt from taxation under section 501(a) to another organization is to retain its character as gross investment income with respect to the recipient organization for purposes of the one-third limit on gross investment income. This will prevent a private foundation from avoiding the one-third limit by transferring its endowment to a trust and will also prevent the trust from avoiding the restrictions in the bill by the assertion that it is operating for the benefit of an organization that is not a private foundation.

The organizations which usually will be excluded from the definition of private foundations if they satisfy this provision include symphony societies, garden clubs, alumni associations, Boy Scouts, Parent-Teacher Associations and many other membership organizations.

Another category of organizations removed from the definition of private foundations comprises those organizations which are organized and operated exclusively for the benefit of one or more of the 30-percent organizations or broadly based organizations described above, provided that they are operated, supervised, or controlled by one or more such organizations, or in connection with one such organization, and are not controlled directly or indirectly by disqualified persons (other than foundation managers, 30-percent organizations, and broadly based organizations described above).[24] In general, religious

[24] Under the bill, this third category applies to organizations "organized, and at all times thereafter is operated, exclusively for the benefit of * * * one or more "organizations" in the first and second categories. In the case of existing organizations, these tests apply as of the effective date of the provision, and an organization may qualify even though its original governing instrument did not so limit its purposes and even though it operated before the effective date for some other exempt purposes. However, this does not change the basic requirement for exemption in section 501(c)(3) that the organizations have been organized and operated exclusively for the exempt purposes listed in that provision.

organizations other than churches, organizations organized and operated for the benefit of a specific school and also controlled by or operated in connection with that school, university presses, and similar organizations are examples of organizations expected to qualify for this category.

The committee in general accepted the definition as set forth above but made the following modifications or clarifications in it:

(a) It provided a definition of support for purposes of this provision. In this regard it adopted the definition contained in the current regulations modified to include in support amounts received from the exercise or performance by an organization of its exempt purpose or function.

In the bill, the support tests are generally to be computed on the basis of the nature of the organization's "normal" sources of support, although of course, it is recognized that in most cases the proportions of support an organization receives from different sources will vary from year to year. Under existing law an organization's "normal" source of support is considered in determining if it is a publicly supported organization. Existing regulations [25] determine what is "normal" on the basis of a 4-year moving average. In general, the committee anticipates that this approach will be used in applying the "normal" tests of the bill. Appropriate modifications are expected to be made, however, to take into account the likelihood that on occasion an organization may receive an unusual grant or bequest which should not affect its status. For example, one approach could be to determine whether the organization meets the support test in 3 out of 4 consecutive years.

(b) In defining the one-third of the organization's support which must come from the public, the bill includes gross receipts from activities by the organization which are not unrelated trade or business activities. This, however, does not include receipts in the year from any persons which are in excess of 1 percent of the organization's support or (under the committee's amendment) $5,000, whichever is greater. The term "person" as used in the Internal Revenue Code does not include governmental units, so that under the House bill an organization which has only one contributor and whose support comes from government contract work might avoid classification as a private foundation (or, depending upon the interpretation, might be regarded as being a private foundation even though its governmental support really was broadly based). The committee provided that amounts received from government contracts (on a contract-by-contract basis) would be included in the qualifying activity income only to the extent they do not exceed 1 percent of the organization's support, or $5,000, whichever is the greater. However, government contracts as well as the other listed types of support (receipts from admissions, sales, services, and facilities) are included in the one-third that must come from the public, only if the receipts are from activities which are not unrelated trades or businesses (within the meaning of section 513).

(c) The committee provided that an organization which meets all of the tests of the third category described above except that it is

[25] Regs. sec. 1.170-2(b)(5)(iii).

operated in connection with two or more specific schools nevertheless may qualify where all the beneficiaries are educational organizations. One example of such a situation that has come to the committee's attention is an organization that meets all the detailed requirements of the House bill regarding the third category, described above, except that it is operated in connection with a university in one part of the country and a junior college in another part of the country. The committee made this change in the third category in order not to interfere with this avenue of communication and cooperation between educational institutions.

(d) The committee provided that an organization which is formed outside the United States, if it meets the definition of a private foundation, is to be treated as such despite the place of its organization. Accordingly, a gift by a domestic private foundation to a foreign nonoperating private foundation will not be a qualifying distribution only if the one year payout requirement is met, but a gift to a foreign operating foundation will qualify under the same circumstances that a gift to a domestic operating foundation would qualify.

The committee provided a series of modifications of the private foundations rules to take account of the fact that some of the rules could not easily be applied in practice to foreign organizations. In their case the audit-fee tax is to be 2 percent of the gross investment income received from sources within the United States. The requirements regarding change of status, governing instruments, self-dealing, minimum distributions, excess business holdings, jeopardy investments, and limitations on activities will not apply to foreign private foundations if no significant part of their support (other than investment income) was derived from United States sources. However, in general, such a foreign private foundation is to lose its exemption under the Internal Revenue Code if it engages in any of the acts that would have justified a doubling of the taxes imposed upon the organization (that is, repeated or willful and flagrant violations) had it been a domestic organization engaging in those same acts. Also, no income, gift, or estate tax deductions would be allowed to a foreign organization that has lost its exempt status under these circumstances. In effect, such an organization would be treated as a taxable nonresident alien.

(e) The committee provided that a foundation which is run in conjunction with an organization exempt under paragraphs (4), (5), or (6) of section 501(c) (such as a social welfare organization, labor or agricultural organization, business league, real estate board, etc.) which is publicly supported is to be treated as meeting the public support test for purposes of being a public charity rather than a private foundation. This is an addition to present law, under which an organization is treated as being publicly supported to the extent that its support is received as grants or contributions from an organization that is publicly supported.

Effective date.—These provisions take effect January 1, 1970. However, if an organization was a private foundation on October 9, 1969, then it will continue to be a private foundation for purposes of these provisions until its status is terminated in the manner described above, in *Change of Status*.

11. Private Operating Foundation Definition (sec. 101(b) of the bill and sec. 4942 of the code)

Present law.—The term "operating foundation" is not in present law but is sometimes used to describe the type of organization contributions to which qualify for the unlimited charitable contribution deduction even though they do not qualify for the 30-percent deduction provision of present law. Essentially these are organizations which, although lacking general public support, devote most of their earnings and much of their assets directly to the conduct of their educational, charitable, and religious purposes, as distinct from merely making grants to other organizations for these purposes. More specifically, in order to qualify for this treatment under present law, substantially more than half of the organization's assets and substantially all of its income must be used or expended directly for its exempt purpose or function.

General reasons for change.—A definition of an operating foundation is needed under the House bill and the committee's amendments, first, because an operating foundation (as distinct from private foundations generally) can be the recipient of grants from a private foundation without having to spend the funds so received currently within one year with the funds nevertheless qualifying as expenditures of income by the donating private foundation. Second, insofar as the committee amendments are concerned, an operating foundation (as distinct from a nonoperating private foundation) is not limited to a 40-year life as an exempt organization. Third, under both the House bill and the committee amendments, charitable contribution donations to operating foundations are eligible for the 50-percent charitable contribution deduction. Fourth, while an operating foundation is required to spend or use substantially all of its income for the active conduct of its educational or charitable purposes, it is not subject to the 5-percent minimum payout requirement nor required to expend its entire income.

Explanation of provisions.—The House bill and the committee amendments provide that an operating foundation is a private foundation substantially all (at least 85 percent) of whose income is spent directly for the active conduct of its activities representing the purpose or function for which it is organized and operated. Under the House bill, it must also meet one of two other tests. Under the committee's amendment, it may meet either one of the same tests or a third test. The first of these alternative tests under both versions of the bill requires that substantially more than half (at least 65 percent) of the assets of the foundation must be devoted directly to the activities for which it is organized or to functionally related businesses. (This alternative is essentially the same as present law.) The second alternative under both versions of the bill covers cases where the organization normally receives substantially all of its support (other than gross investment income) from 5 or more exempt organizations and from the general public. However, in this case not more than 25 percent of the foundation's support (other than gross investment income) may be received from any one of these exempt organizations and, under a committee amendment, not more than half of its support may come from its investment income. This second alternative has been added because it appears that a number of charitable foundations are regularly used by many private foundations to funnel charitable contributions into certain areas. The operating foundations, in such circumstances, have developed an expertise which permits them to make effective use of the money through grant programs or otherwise.

The third alternative provided by the committee is where an organization's endowment (plus any other assets not devoted directly to the active conduct of the activities for which it is organized), based upon a 4-percent rate of return, is no more than adequate to meet its current operating expenses. (The 4-percent rate will vary in accordance with any changes made by the Secretary of the Treasury in the 5-percent minimum payout requirement and will be four-fifths of the minimum payout requirement rate.)

This definition retains the concept that the income of the organization must be expended currently for its specialized purposes. The assets alternative is intended to apply particularly to organizations such as museums, Callaway Gardens (a horticultural and recreational area for the use of the public at Pine Mountain, Georgia), Colonial Williamsburg (described above in *Stock Ownership Limitation*), and Jackson Hole (which operates functionally related businesses in connection with public parks and its exempt purposes).

The support alternative is intended to focus primarily upon special-purpose foundations, such as learned societies, associations of libraries, and organizations which have developed an expertise in certain substantive areas and which provide for the independent granting of funds and direction of research in those specialized substantive areas. (See *Limitations as to Activities of Foundations*, above.)

The endowment alternative is intended to apply to organizations which actively conduct charitable activities (as distinguished from merely making grants) but where their personal services are so great in relationship to charitable assets that the cost of those services cannot be met out of small endowments. Examples of organizations to which this alternative is expected to apply include Longwood Gardens, Sleepy Hollow Restoration, and research organizations.

Effective date.—This provision applies to taxable years beginning after December 31, 1969.

12. Hospitals (sec. 101 of the bill and sec. 501 of the code)

Present law.—Hospitals qualify for exempt status and may receive deductible charitable contributions as "charitable" organizations.

General reasons for change.—In 1956, the Internal Revenue Service ruled that hospitals (unlike educational organizations, churches, and others) must provide some significant amount of charitable services without charge or below cost, to the extent of their financial ability and the "charitable demands of the community," in order to be exempt as "charitable" organizations.

The Internal Revenue Service has, however, issued a ruling on October 8, 1969, indicating that hospitals, if they meet all the other requirements of section 501(c)(3), are exempt under that provision, whether or not they provide charitable services on a no-cost or low-cost basis.

Explanation of provisions.—The committee deleted from the bill those provisions which would have conformed the code to the result reached by the 1969 ruling. The committee decided to reexamine this matter in connection with pending legislation on Medicare and Medicaid.

13. Effective Dates (secs. 101 (k) and (l) of the bill)

The provisions described above generally take effect on January 1, 1970.

Explanation of provisions.—The committee generally adopted the effective dates in the House bill with the following exceptions:

(1) Foundations whose governing instruments cannot be changed to comply with the income distribution rules or with business ownership rules are not to be affected by these rules until the instruments can be changed. Similar provisions already appear in the bill with regard to accumulations and with regard to the provision requiring existing private foundations to reform their governing instruments in accordance with the language of the bill.

(2) The House bill provides that the self-dealing rules are not to apply to fair price sales to disqualified persons in the case of property held by the foundation on May 26, 1969, if the foundation is required to dispose of the property in order to meet the business holding requirements. The committee changed the date to October 9, 1969, and extended this treatment to exchanges and other dispositions where the foundation receives in return amounts equal to or in excess of the fair market value of the property which was exchanged. Such an exchange will not be treated as a purchase (for purposes of section 4943) if made pursuant to a plan for disposition of excess business holdings. The committee also agreed that the rule as to the sales of business holdings is also to apply to later acquired property received under wills executed before October 9, 1969, or where the property was received under the mandatory provisions of trusts or documents transferring property in trust if such provisions were irrevocable on October 9, 1969, and at all times thereafter.

(3) The committee amendments provide that many of the provisions are to take effect on January 1, 1970, and other listed provisions apply to taxable years beginning after December 31, 1969. Some of the definition provisions take effect on October 9, 1969. This is done because the basic taxable year rule did not provide sufficient precision. These changes do not represent a change in policy from the House bill.

B. OTHER TAX-EXEMPT ORGANIZATIONS

1. The "Clay Brown" provision or Debt-financed Property (sec. 121(d) of the bill and secs. 512 and 514 of the code)

Present law.—Under present law, charities and some of the other types of exempt organizations are subject to tax on rental income from real property to the extent the property was acquired with borrowed money. However, this provision does not apply to all tax-exempt organizations, and there is an important exception which excludes rental income from a lease of 5 years or less. In addition, there is a question as to whether the tax applies to income from the leasing by a tax-exempt organization of assets constituting a going business.

General reasons for change.—During the past several years a device has been developing which exploits weaknesses in the taxation of unrelated business income of tax-exempt organizations. The net effect is the use of the tax exemption to reduce taxes for owners of a business by converting ordinary income to capital gain and eventually to the acquisition of the business by a tax-exempt organization entirely out of the earnings of that business. This device was challenged by the Government in the courts but existing law was construed by the Supreme Court to support it in *Clay B. Brown.*

The typical *Clay Brown* situation presents the following series of events: A sells an incorporated business to B, a charitable foundation, which makes a small (or no) down payment and agrees to pay the balance of the purchase price only out of profits to be derived from the property. B liquidates the corporation and then leases the business assets to C, a new corporation formed to operate the business. A (collectively, the stockholders of the original business) manages the business for C and frequently holds a substantial minority interest in C. C pays 80 percent of its business profits as "rent" to B, which then passes on 90 percent of those receipts to A until the original purchase price is paid in full. B has no obligation to pay A out of any funds other than the "rent" paid by C.

In this manner, in the *Clay Brown* case, the owners of the business (A in the above example) were able to realize increased after-tax income and the exempt organization was able to acquire the ownership of a business valued at $1.3 million without the investment of its own funds. In 1965 the Supreme Court held that the owners were entitled to treat as capital gains (reported on the installment basis) the money they received from the foundation.

In the recent (1969) *University Hill Foundation* case, the Tax Court held that an organization engaged in essentially the Clay Brown type of operation on a large scale did not lose its tax exemption, nor did it have unrelated business income. This case involved a tax-exempt organization established for the purpose of raising funds for a church-supported university. Twenty-four businesses were acquired by the organization from 1945 to 1954. The economic effect of the acquisitions was to divide the net income of each business, 20 percent to the new operators, 8 percent to the exempt organization, and 72 percent as installments on the purchase price to the sellers of the business. As was true in the *Clay Brown* case, the 72 percent was taxable to the sellers at capital gain rates. The court found that the organization was entitled to exemption as a charitable organization (because it was not actively engaged in business); that the organization was not taxable as a "feeder organization" because for this purpose, trade or business does not include the rental of real property (including personal property leased with the realty) and because it was not a controlling factor that the real property was not the essential element in the transaction; and that the rent received from the lessees was not taxable as unrelated business income because this concept does not include "rentals from real property (including personal property leased with real property)."

Other variants of the debt-financed property problem have also been used.

Explanation of provision.—Both the House bill and the committee amendments provide that all exempt organizations' income from "debt-financed" property, which is unrelated to their exempt function, is to be subject to tax in the proportion in which the property is financed by the debt. Thus, for example, if a business or investment property is acquired subject to an 80 percent mortgage, 80 percent of the income and 80 percent of the deductions are to be taken into account for tax purposes. As the mortgage is paid off, the percentage taken into account diminishes. Capital gains on the sale of debt-financed property also are taxed in the same proportions.

The bill defines debt-financed property to be all property (e.g., rental real estate, tangible personal property, corporate stock) which is held to produce income and with respect to which there is an "acquisition indebtedness" at any time during the taxable year (or during the preceding 12 months, if the property is disposed of during the year).

The House bill would except from this definition the following: (1) property where all of its use is related to the exercise or performance of the organization's exempt function; (2) property where all of its income is already subject to tax as income from the conduct of an unrelated trade or business; (3) property where all of its income is derived from research activities excepted from the present unrelated business income tax; and (4) property where all of its use is in a trade or business exempted from tax because substantially all the work is performed without compensation, the business is carried on primarily for the convenience of members, students, patients, etc., or the business is the selling of merchandise; substantially all of which was received as gifts (sec. 513(a) (1), (2), and (3)).

The committee approves of these exceptions but believes that they are somewhat too limited. Where the use of the property is "related," the House bill provides an exemption only if it is "all" related. The committee amendments exempt from the tax income from property where "substantially" all of its use is substantially related to its exempt purpose. In addition, if less than substantially all of its use is related, then the term debt-financed property is not to include the property "to the extent" that its use is related to the organization's exempt purpose or to a purpose described in (3) or (4) above, or where the income from the property is unrelated business income. The committee believes that its amendments provide a more appropriate test of what constitutes related.

The committee also provided that where a debt-financed building is owned by an exempt holding company (or other exempt organization) and used by any related exempt organization, the property of the holding company (or other exempt organization) is not to be classified as debt-financed property to the extent it is used by the related exempt organization (whether or not a section 501(c)(3) organization) in the performance of its exempt functions. The committee believes that this amendment is appropriate since it is consistent with the purposes and functions of the exempt organization.

Both the committee and the House versions of the bill provide that the tax on unrelated debt-financed income is not to apply to income from real property, located in the neighborhood of the exempt organization, which it plans to devote to exempt uses within 10 years of the time of acquisition. A more liberal 15-year rule is established for churches, and it is not required that the property be in the neighborhood of the church.

Under the bill, income producing property is considered to be debt-financed property (making income from it taxable) only where there is an "acquisition indebtedness" attributable to it. 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. Thus, for example, where a church has a portfolio of investments with no debt, and subsequently incurs a debt to construct a church related building, such as a seminary, such debt will not be considered acquisition indebtedness with respect to the investment portfolio.

If an indebtedness is incurred after the property is acquired or improved, it would not be "acquisition indebtedness" unless its incurrence was reasonably foreseeable at the time of the acquisition or improvement. If property is acquired subject to a mortgage, the mortgage is to be treated as an acquisition indebtedness incurred by the organization when the property is acquired.

Under the bill, as indicated above, unrelated debt-financed income will be subject to tax only if the income arises from property acquired or improved with borrowed funds and the production of the income is unrelated to the educational, charitable, religious, or other purpose constituting the basis of the organization's tax exemption. For example, where a charitable organization pledges recently acquired property to borrow funds which it immediately uses for its tax exempt purposes and neither the donor of the pledged property nor any other private individual receive any direct or indirect financial benefit (either as a result of the transfer of the property or the borrowing by the organization) it will be assumed that the borrowing is for the organization's exempt purposes. Of course, this could not be used to circumvent this provision where investment property is also acquired and the borrowing would not have occurred but for the investment property acquisition.

The bill excepts from the term "acquisition indebtedness" property subject to indebtedness which an exempt organization receives by devise, by bequest, or, under certain conditions, by gift. This exception permits organizations receiving such property a 10-year period of time within which to dispose of it free of tax or to retain it and reduce or discharge the indebtedness on it with tax-free income. The bill also would not treat the extension, renewal, or refinancing of an existing indebtedness as the creation of a new indebtedness. Further, 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—such as the indebtedness incurred by a credit union in accepting deposits from its members. 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 committee intent is that property acquired under a life income contract is not to be treated as debt-financed property if none of the payments received by any life beneficiary are treated for tax purposes as the proceeds of a sale or exchange of part or all of the property transferred to the exempt organization. Under a life income contract, an individual transfers property to a trust or a fund subject to a contract providing that the income is to be paid to the donor, or to other private persons, for a period of time (generally for life) with the remainder interest going to charity. These life income contracts do not represent the type of obligation intended to be treated as "acquisition indebtedness."

The computation of unrelated debt-financed income (the amount subject to tax) is determined by applying to the total gross income and deductions attributable to debt-financed property the fraction:

$$\frac{\text{average acquisition indebtedness for the taxable year}}{\text{average adjusted basis of the property during the taxable year}}.$$

For purposes of the numerator of the fraction, acquisition indebtedness is to be averaged over the taxable year. The averaging mechanism precludes an exempt organization from avoiding the tax by using other available funds to pay off the indebtedness immediately before any fixed determination date. If debt-financed property is disposed of during the year, "average acquisition indebtedness" would mean the highest acquisition indebtedness during the preceding 12 months. Without such a rule, an exempt organization could avoid tax by using other resources to discharge indebtedness before the end of one taxable year and dispose of property after the beginning of the next taxable year.

For purposes of the denominator of the fraction, adjusted basis would be the average adjusted basis for the portion of the year during which the property is held by the exempt organization. The use of average adjusted basis is for purposes only of determining the fraction. Where property is disposed of, gain or loss will, as usual, be computed with reference to adjusted basis at the time of disposition.

If property is distributed by a corporation in liquidation to the exempt organization, the exempt organization is to use the basis of the distributing corporation, with adjustment for any gain recognized on the distribution either to the exempt organization (as, for example, might be the case if the exempt organization had an acquisition indebtedness applicable to its stock in the distributing corporation) or to the taxable corporation (for example, as recapture of depreciation under sections 1245 or 1250). This rule would prevent an exempt organization from acquiring the property in a taxable subsidiary to secure accelerated depreciation during the first several years of the life of the property, enabling the subsidiary to pay off a large part of the indebtedness during those years after which the exempt organization would obtain a stepped-up basis on liquidation of the subsidiary.

The percentage used in determining the taxable portion of total gross income also is to be used to compute the allowable portion of deductions "directly connected with" the debt-financed property or the income from it. The direct connection requirement is carried over from present law (sec. 512). In general the bill allows all deductions that would be allowed to a normal taxpayer, to the extent consistent with the purpose of the bill and the nature of the special problems to which they are directed. For example, net operating loss and charitable contribution deductions would be allowed, subject to the limitations imposed by existing law on organizations taxable on unrelated business income (e.g., the percentage limitations on the charitable deduction are computed with reference only to the organization's unrelated business income, not its total income).

The deduction for depreciation would be restricted to the straight-line method, however. Accelerated depreciation ordinarily has the effect of deferring tax on income from depreciable property. However, under the bill, an exempt organization would become a taxpayer with respect to the debt-financed property only for a limited period of time—while acquisition indebtedness remains outstanding—and would during that time be taxed on a declining proportion of its income from this property. In that setting, accelerated depreciation can be used for more than mere tax deferral; it can be used to reduce the total amount of the tax payable or, in some situations, eliminate tax altogether. It accomplishes that result by enlarging deductions in early years, in which the taxes would otherwise be high because of the large amount of indebtedness outstanding. To the extent that the useful life of the property is longer than the term of the indebtedness, acceleration of depreciation shields otherwise taxable income by means of deductions shifted from periods in which no tax at all would be paid. Hence, the bill's limitation of depreciation to the straight-line method is necessary to make this approach meaningful.

If property is used partly for exempt and partly for nonexempt purposes, the income and deductions attributable to the exempt uses are excluded from the computation of unrelated debt-financed income, and allocations are to be made, where appropriate, for acquisition indebtedness, adjusted basis, and deductions assignable to the property.

The provision is generally effective for 1970 and later years, but for years before 1972 only indebtedness incurred on or after June 28, 1966, is to be taken into account.

2. Extension of Unrelated Business Income Tax to All Exempt Organizations (secs. 121 (a), (b), and (f) of the bill and secs. 511 and 512 of the code)

Present law.—Under present law the tax on unrelated business income applies only to certain tax-exempt organizations. These include:

(a) Charitable, educational, and religious organizations (other than churches or conventions of churches);

(b) Labor and agricultural organizations;

(c) Chambers of commerce, business leagues, real estate boards, and similar organizations;

(d) Mutual organizations which insure deposits in building and loan associations and mutual savings banks; and

(e) Employees' profit sharing trusts and trusts formed to pay (nondiscriminatory) supplemental unemployment compensation.

In general, these organizations are subject to the regular corporate income tax (or the tax applicable to trusts) on their active business income which arises from activities which are unrelated to the exempt purposes of the organizations.

General reasons for change.—In recent years, many of the exempt organizations not now subject to the unrelated business income tax—such as churches, social clubs, fraternal beneficiary societies, etc.—have begun to engage in substantial commercial activity. For example, numerous business activities of churches have come to the attention of the committee. Some churches are engaged in operating publishing houses, hotels, factories, radio and TV stations, parking lots, newspapers, bakeries, restaurants, etc. Furthermore, it is difficult to justify taxing a university or hospital which runs a public restaurant or hotel or other business and not tax a country club or lodge engaged in similar activity.

Explanation of provision.—Both the House bill and the committee amendments extend the unrelated business income tax to all exempt organizations (except United States instrumentalities created and made tax exempt by a specific act of Congress). The organizations newly made subject to this tax include churches and conventions or associations of churches, social welfare organizations, social clubs, fraternal beneficiary societies, employees' beneficiary organizations, teachers retirement fund associations, benevolent life insurance associations, cemetery companies, credit unions, mutual insurance companies, and farmers cooperatives formed to finance crop operations.

As under present law, this tax does not apply unless the business is "regularly" carried on and therefore does not apply, for example, in cases where income is derived from an annual athletic exhibition. In the case of membership organizations, income resulting from charges to members for goods, facilities, and services supplied in carrying out the exempt function is not subject to tax.

The bill continues to exclude from unrelated business income earnings from businesses related to an organization's exempt function—such as the earnings received directly or indirectly from its members by a fraternal beneficiary society in providing fraternal activities or insurance benefits for its members or their dependents. For example, if the fraternal beneficiary society directly provides insurance for its members and their dependents, or arranges with an insurance company to make group insurance available to them, the amounts received by the society from its members for providing, or from the insurance company for arranging, for this exempt function will continue to be excluded from the unrelated business income tax.

The bill contains several administrative provisions including one providing that no audit of a church, its integrated auxiliaries, or a convention or association of churches is to be made unless the principal internal revenue officer for the region believes the church may be engaged in a taxable activity and notifies the church in advance of the examination. This provision is intended to protect churches from unnecessary tax audits in the interest of not interfering with the internal financial matters of churches. Another provision will assist the Internal Revenue Service in its administrative functions by requiring a transferor to report a transfer of income-producing property if the transferor knows the transferee is an exempt organization and the property has a value of more than $50,000.

The bill, in extending the unrelated business income tax to churches, provides a period of time (through taxable years beginning before January 1, 1976) for churches to dispose of unrelated businesses (operated before May 27, 1969) or to spin them off into separate taxable corporations.

The committee adopted the House provision extending the unrelated business income tax to virtually all exempt organizations, with the following modifications:

(1) Present law, in distinguishing between passive income which is free of tax and active business income which is subject to tax, provides an exclusion from the unrelated business income tax for all rents from real property and personal property leased with the real property. The committee amendments limit the exclusion for rents of personal property to cases where the rent from the personal property is an incidental amount of the total rent. The personal property generally is to be considered incidental if the rent attributable to it does not ex-

ceed 10 percent of the total rent received under the lease (or leases, if two or more leases are involved). Further, where the rent attributable to the personal property is 50 percent or more of the total rent, the total rent (including the rent from real property) is to be taxed. In addition, the amendments would tax property rentals of both real and personal property where the rentals are measured by reference to the net income from the property. They would exclude from unrelated business income, however, rentals based upon a percentage of gross receipts. This incorporates the test for "passive" rentals used in dealing with real estate investment trusts.

These provisions would apply even where two or more leases are used, for example, one for the realty and another for the personalty. These amendments are intended to prevent an escape from the tax on unrelated business income in those cases where an exempt organization owns an operating business but leases the business assets to an independent management company. In such a case it receives most of the profits from the business in the form of "passive rents" and comes under the existing exclusion from real property and personalty leased with real property. The committee amendments are not intended to create any inference as to the Tax Court decision in the *University Hill Foundation* case or other cases still in litigation.

(2) The committee amendments make it clear that related income includes income received from members for providing goods, facilities, or services to the members' dependents. The committee believes that the word "guests" as it now appears in the bill is intended to include dependents, but adds the word "dependents" to remove any doubt.

(3) Under the committee amendments, the $1,000 specific deduction allowed in present law in computing the unrelated business income tax is to be available for each parish, individual church, district, or other local unit in the case of a diocese, province of a religious order or convention or association of churches. This rule would be applicable only to the extent that the individual parish, district, etc., realized the income from an unrelated trade or business regularly carried on by it.

(4) Under present law, a voluntary employees' beneficiary association (exempt under sec. 501(c)(9)) providing life, sickness, accident and other benefits to members must derive 85 percent or more of its income from its members. With the imposition of the tax on unrelated business income on organizations in this category (and also the investment income tax referred to subsequently), the House concluded that the 85 percent income test was no longer necessary. As a result, voluntary employees' beneficiary associations under the House bill generally are to be exempt whether or not they meet the 85 percent test in the same manner as is now the case for associations where the members are United States Government employees (sec. 501(c)(10)). For this reason, there is no substantive difference remaining between these two provisions and the committee amendments combine these two categories.

In addition, the committee amendments specify that those voluntary employees' beneficiary associations which provide pension and retirement benefits for their members and are taxed under special life insurance company provisions (secs. 801(b)(2)(B), 802 and 810(e)), are to be restored to an exempt category under section 501(c) (as was previously the case), but will be subject to the unrelated business income tax. The committee believes that, consistent with the removal of the 85 percent test, it is appropriate to place them back in an exempt category, as long as their unrelated business income will be subject to tax, and their pension or retirement benefits do not discriminate in favor of high paid employees, or officers, shareholders, etc., and so long as the fund must be used for pensions and retirement benefits. For purposes of this provision, the term retirement benefits is intended to include customary and incidental benefits, such as death benefits within the limits permissible under section 401.

(5) In defining what constitutes unrelated business income, the committee amendments provide that when an exempt holding company pays any amount of its net income to a tax-exempt organization, and files a consolidated return with that organization, the holding company is to be treated as organized and operated for the same purposes as the exempt organization. This means that if the income of the holding company is related to the exempt functions of the exempt organization, it will be classified as related business income and therefore not subject to tax. The committee believes that this is appropriate, since it sees no reason why the income of the holding company should be taxed when it is derived from an activity which would be treated as an exempt function of an affiliated exempt organization.

(6) The committee amendments provide that the unrelated business income tax is not to apply to a religious order or to an eductional institution maintained by such a religious order that has operated an unrelated business, which provides services under a license issued by a Federal regulatory agency, for 10 years or more, if not less than 90 percent of the earnings from the unrelated business each year are devoted to religious, charitable, or educational purposes, and it is established to the satisfaction of the Secretary, or his delegate, that rates and other charges and services provided by such a business are fully competitive with and do not exploit similar businesses operating in the same general area. In such a case there are no competitive advantages obtained by the business from the exemption, and where the exempt organization has for a long time depended on this income, to make it forego approximately half of it would constitute a serious hardship.

(7) Under present law, an organization (known as a "feeder" organization) operated primarily to carry on a trade or business for profit is not exempt even though all its profits are payable to one or more exempt organizations (sec. 502). On the other hand, under present law, the unrelated business income tax does not apply to a business in which substantially all the work in carrying on the business is performed for the organization without compensation or to a business (such as a thrift shop) which sells merchandise, substantially all of which is received by the organizations as gifts or contributions (sec. 513(a) (1) and (3)). These exceptions do not apply to feeder organizations. The committee amendments extend these exceptions to cases where such businesses, regardless of whether the business is run for the benefit of one or more exempt organizations, even though in a separate organization or otherwise. The committee believes that this amendment is appropriate because a business operated by an exempt organization through a separate entity in these cases should not be subject to tax if the business would be exempt from tax if operated directly by the exempt organization. Thus, this amendment merely makes these rules consistent.

In the case of churches, the committee intends that the term unrelated business income does not include the operation and maintenance of cemeteries, the conduct of charitable institutions, the sale of religious articles and the printing, distribution and sale of religious pamphlets, tracts, calendars, papers, books and magazines with a substantial religious content (even though the document might contain a small amount of advertising), as long as these activities are carried on in connection with the church.

The committee, also, intends that when organizations send out low cost articles incidental to the solicitation of charitable contributions, the amounts received are not to be considered as being in exchange for the low cost articles where it is clear that the contributions, less a reasonable administrative cost, fully accrue to the exempt organization.

The committee also intends that merely because an unrelated business income tax is payable by an organization does not mean that it is to retain its exemption if the conduct of the unrelated business activity would, without regard to the unrelated business income tax, result in the loss of the exemption.

3. Taxation of Investment Income of Social, Fraternal, and Similar Organizations (sec. 121(b) of the bill and 512 of the code)

Present law.—Under present law the investment income of social clubs, fraternal beneficiary societies, and employees' beneficiary associations is exempt from income tax.

General reasons for change.—Since the tax exemption for social clubs and other groups is designed to allow individuals to join together to provide recreational or social facilities or other benefits on a mutual basis, without tax consequences, the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership. Under such circumstances, the individual is in substantially the same position as if he had spent his income on pleasure or recreation (or other benefits) without the intervening separate organization. However, where the organization receives income from sources outside the membership, such as income from investments (or in the case of employee benefit associations, from the employer), upon which no tax is paid, the membership receives a benefit not contemplated by the exemption in that untaxed dollars can be used by the organization to provide pleasure or recreation (or other benefits) to its membership. For example, if a social club were to receive $10,000 of untaxed income from investments in securities, it could use that $10,000 to reduce the cost or increase the services it provides to its members. In such a case, the exemption is no longer simply allowing individuals to join together for recreation or pleasure without tax consequences. Rather, it is bestowing a substantial additional advantage to the members of the club by allowing tax-free dollars to be used for their personal recreational or pleasure purposes. The extension of the exemption to such investment income is, therefore, a distortion of its purpose.

The use of investment income by employees' beneficiary associations for purposes other than benefits to members creates a similar problem. On the other hand, receipt of investment income for use in the insurance function of such organizations presents a different set of considerations. Investment income is an integral part of the insurance function of such organizations as it is part of the traditional and normal manner in which insurance companies provide for the covering of losses. The correct treatment of this income, then, is related to the overall question of the treatment of the insurance function of all exempt organizations presently permitted to engage in such activities.

Explanation of provision.—The House bill provides for the taxation (at regular corporate rates) of the investment income of social clubs, fraternal beneficiary associations and employees' beneficiary associations. Under the House bill, however, this does not apply to the income of fraternal beneficiary associations and employees' beneficiary associations to the extent their income is set aside to be used only for religious, charitable, scientific, literary, educational etc. purposes (the purposes specified in sec. 170(c)(4)), or for the exempt insurance function of these organizations. If in any year, an amount is taken out of the set aside and used for any other purpose, however, this amount is then to be subject to tax.

The committee amendments modify the House bill by excluding fraternal beneficiary associations from the tax on investment income since for the most part they do not use their investment income for the benefit of their members. In addition, a new category of exemption for fraternal beneficiary associations is set forth which applies to fraternal organizations operating under the lodge system where the fraternal activities are exclusively religious, charitable or educational in nature and no insurance is provided for the members. The committee believes that it is appropriate to provide a separate exempt category for those fraternal beneficiary associations (such as the Masons) which do not provide insurance for their members. This more properly describes the different types of fraternal associations.

The committee amendments also extend the exemption from the investment income tax available in the House bill for fraternal beneficiary associations and employees' beneficiary associations in the case of amounts they set aside or use for religious, charitable or educational purposes to the other types of organizations (the social clubs) to which the investment income tax is to apply. The committee believes that to the extent that they use their income for these charitable purposes, they too should be allowed an exemption from the tax on investment income. In extending the exemption, the committee intends in the case of national organizations of college fraternities and sororities that amounts set aside for scholarships, student loans, loans on local chapter housing, leadership and citizenship schools and services, and similar activities, be classified as amounts used for educational or charitable purposes under this provision. This exception would also extend to any other educational or charitable activities of these or other exempt organizations.

The committee's bill also provides that income will be treated as set aside for the specified benefits where it is used for the reasonable cost of administration of benefit programs, as well as the payment of the benefits themselves or the reasonable cost of administration of religious, educational or charitable activities.

In addition, the committee's bill provides that the tax on investment income is not to apply to the gain on the sale of assets used by the organizations in the performance of their exempt functions to the extent the proceeds are reinvested in assets used for such purposes within a period beginning 1 year before the date of sale and ending three years after that date. This provision is to be implemented by rules similar to those provided where a taxpayer sells or exchanges his residence (sec. 1034). The committee believes that it is appropriate not to apply the tax on investment income in this case because the organization is merely reinvesting the funds formerly used for the benefit of its members in other types of assets to be used for the same purpose. They are not being withdrawn for gain by the members of the organization. For example, where a social club sells its clubhouse and uses the entire proceeds to build or purchase a larger clubhouse, the gain on the sale will not be taxed if the proceeds are reinvested in the new clubhouse within three years.

The committee in providing the tax on investment income of social clubs does not intend that this will have any bearing on whether an exemption should be granted, or continued, if significant income earning activities are carried on by the organization.

4. Interest, Rents, and Royalties From Controlled Corporations (sec. 121(b) of the bill and sec. 512 of the code)

Present law.—Under present law, rent, interest, and royalty expenses are deductible in computing the income of a business. On the other hand, receipt of such income by tax-exempt organizations generally is not subject to tax.

General reasons for change.—Some exempt organizations "rent" their physical plant to a wholly owned taxable corporation for 80 percent or 90 percent of all the net profits (before taxes and before the rent deduction). This arrangement enables the taxable corporation to escape nearly all of its income taxes because of the large "rent" deduction. While courts have occasionally disallowed some, or all, of the rent deductions, the issue is a difficult one for the Internal Revenue Service.

Explanation of provisions.—Both the House bill and the committee amendments provide that where a tax-exempt organization owns more than 80 percent of a taxable subsidiary, the interest, annuities, royalties and rents received by it are to be treated as "unrelated business income" and are subject to tax in the hands of the exempt organizations. The deductions connected with the production of this income are allowed.

The committee's bill modifies this provision slightly by providing that where the subsidiary is also an exempt organization, it is to apply only in the proportion that the subsidiary's income is unrelated business income to it. In addition, where the operation of a taxable controlled corporation is "functionally related" to the exempt purposes of the controlling exempt organization the committee amendments provide that income from the taxable subsidiary is to be treated as related income and therefore not subject to tax in proportion to the subsidiary's income from the functionally related activities. The committee believes that these modifications are appropriate, since, in the case of a controlled exempt corporation, there is no intention to tax its related income.

5. Limitation on Deductions of Nonexempt Membership Organizations (sec. 121(b) of the bill and sec. 277 of the code)

Present law.—Certain nonexempt organizations which provide services to members on a nonprofit basis realize investment income, or income from providing services to nonmembers, which is used to defray all or part of the cost of providing services to members. Some courts have held that taxable membership organizations cannot create a "loss" by supplying their members services at less than cost. Other courts have held, instead, that such a "loss" is permissible, and that the expenses of providing such services at less than cost offset for tax purposes additional income earned by the organization from investments or other activities.

General reasons for the change.—In some cases, membership organizations, which also have business or investment income, serve their members at less than cost and offset this book loss against their business or investment income and as a result pay no income tax. In an important decision, it was held that a non-exempt water company was not subject to tax when the "losses" in supplying its members water offset its investment income. Other courts have held to the contrary.

Explanation of provision.—Both the House bill and the committee's amendments provide that in the case of a taxable membership organization the deduction for expenses incurred in supplying services, facilities or goods to the members is to be allowed only to the extent of the income received from these members. The purpose is to prevent membership organizations from escaping tax on business or investment income by using this income to serve its members at less than cost and then deducting the book "loss."

The purpose of the provision is to impose a limitation on the amount of deductions in a taxable year for items which are otherwise allowable as deductions in the case of the organizations and activities to which the provision is applicable, and is not intended to provide for the deduction of any item not otherwise deductible.

The House bill does not apply this provision to organizations that are taxable as banking institutions or insurance companies. In addition, the committee's amendments do not apply the provision to a national securities exchange (subject to regulation under the Securities Exchange Act of 1934) or to a commodity market (subject to regulation under the Commodity Exchange Act).

The committee was concerned about the application of this provision to certain nonprofit (but taxable) membership organizations (such as the American Automobile Association) which operate in competition with profitmaking organizations which provide the same type of services as a "loss-leader". Because of this the nonprofit organization must set its dues at the same loss level. The nonprofit organization in such a case offsets the resulting losses with income received from nonmembers (such as income from the sale of advertisements concerned with travel in maps or in travel guides). To deal with this problem, the committee's amendments do not apply if the organization receives prepaid dues income as consideration for services rendered in competition with the charges made by other automobile clubs which are operated as loss leaders for profit organizations.

The committee amendments also provide that where the cost of furnishing services, facilities or goods to members exceeds the income from members, the excess deductions are to be available as carryovers to succeeding years as offsets against income derived from members in those years.

In addition, the committee amendments postpone the effective date of this provision for one year, until January 1, 1971. This will afford Treasury officials an opportunity to consider further adjustments in this provision to better deal with the federal income tax treatment of nonexempt membership corporations.

In adopting this provision, the committee does not intend to create any inference as to the allowability under existing law of a deduction for the excess of such costs over income from members.

6. Income from Advertising, etc. (sec. 121(c) of the bill and sec. 513 of the code)

Present law.—In December 1967, the Treasury Department promulgated regulations under which the income from advertising and similar activities is treated as "unrelated business income" even though such advertising for example may appear in a periodical related to the educational or other exempt purpose of the organization.

General reasons for change.—The committee agrees with the House that the regulations reached an appropriate result in specifying that when an exempt organization carries on an advertising business in competition with other taxpaying advertising businesses, it should pay a tax on the advertising income. The statutory language on which the regulations are based, however, is sufficiently unclear so that substantial litigation could result from these regulations. For this reason, the committee agrees with the House that the regulations, insofar as they apply to advertising and related activities, should be placed in the tax laws.

Explanation of provision.—The House bill provides that the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. It further indicates that, for this purpose, an activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities which may, or may not, be related to the exempt purpose of the organization.

The committee amendments approve the intent of the House provision, but restructure the language of the provision so that it will apply only in the case of advertising and certain other profit-making activities carried on within a larger aggregate of activities, namely a sale by a hospital pharmacy of drugs to persons other than hospital patients and the operation of a race track by an exempt organization. The committee was concerned that, under the House bill, the language of the provision might permit the breaking up of any activity into its component parts and a determination of whether each activity, as such, results in a profit. In view of this, the committee believes that the provision should be limited to advertising and the other indicated activities. In the case of activities not specified in the committee amendments, no inference is intended as to their taxability.

Under this provision, advertising income from publications (whether or not the publications are related to the exempt purpose of the organization) is to constitute unrelated business income to the extent it exceeds the expenses related to the advertising, except that if the editorial aspect of the publication is carried on at a loss, the editorial loss may also be offset against the advertising income from such publication. The language in the bill which refers to the activity "carried on for the production of income" is not intended to refer to the publishing of a magazine with little or no advertising and which is distributed free or at a nominal charge not intended to cover costs. This type of magazine would appear to be published basically as a source of public information and not for the production of income. For a publication to be considered an activity carried on for the production of income, it must be contemplated that the revenues from advertising in the publication or the revenues from sales of the publication, or both, will result in net income (although not necessarily in a particular year).

Under both the House and committee versions of the bill, an organization which publishes more than one magazine, periodical, etc., may treat any of these on a consolidated basis in determining its unrelated trade or business income so long as each such periodical, etc., is "carried on for the production of income." The organization, however, would not be permitted to consolidate the losses of a publication not carried on for the production of income with the profits of other publications which are carried on for profit.

Where an unrelated business activity, such as the sale of advertising in a publication of a tax-exempt organization is carried on in conjunction with an exempt function, the Treasury Department is to prescribe regulations indicating the appropriate methods for allocating income and expenses and other deductions which are attributable to the unrelated activity so as to clearly reflect unrelated business taxable income.

The committee does not intend that this provision modify the treatment under the regulations of the status of institutes and trade shows. Thus it is not intended that a tax apply where an industry trade association derives income from trade shows based on charges made to exhibitors for exhibit space and admission fees charged patrons or viewers of the show. This is only true, however, where the show is not a sales facility for individual exhibitors; its purpose must be the promotion and stimulation of interest in, and demand for, the industry's products in general, and it must be conducted in a manner reasonably calculated to achieve that purpose. Also, for the income from the trade show to be free of tax, the stimulation of demand for the industry's products in general must be one of the purposes for which exemption was granted the industry trade association. In such cases, the activities producing the income for the association from the show—that is, the promotion, organization and conduct of the exhibition—contribute importantly to the achievement of the association's exempt purpose, and as a result the income is related to its exempt purpose.

Consistent with this policy, the conduct of a trade show by a trade association consisting of members who use the type of products exhibited at the show, or consisting of both this type of member and members who produce or sell the products exhibited, for the purpose of exhibiting and explaining the products, is a related trade or business, provided the show is not used as a sales facility for individual exhibitors.

7. Effective Date

The amendments relative to the tax on unrelated business income (including the Clay-Brown amendment relative to unrelated debt-financed income) are to apply to taxable years beginning after December 31, 1969. However, the bill, in extending the unrelated business income tax to churches provides a period of time (through taxable years beginning before January 1, 1976, before the tax applies, in order to enable churches to dispose of unrelated businesses or to spin them off in separate taxable corporations.

In addition, until taxable years beginning after 1971 the new Clay-Brown rules are to apply only where indebtedness has been incurred after the date on which similar bills were introduced in the 89th Congress (June 27, 1966). The transition period will afford organizations with previously initiated unrelated borrowing an opportunity to prevent or minimize tax under the new rules by disposing of their acquisitions for fair value, by discharging indebtedness in full with exempt income or other assets, or at least by reducing the amount of outstanding indebtedness. After the transition period, the new rules would become applicable to all situations of exempt organization investment borrowing.

8. Revenue Effect

The revenue increases under these amendments are estimated at $5 million in the first year, $5 million in the fifth year and $20 million when fully effective.

C. CHARITABLE CONTRIBUTIONS

1. Fifty-percent Charitable Contribution Deduction (sec. 201(a) of the bill and sec. 170(b) of the code)

Present law.—Under present law, the charitable contributions deduction allowed individuals generally is limited to 30 percent of the taxpayer's adjusted gross income. In the case of gifts to certain private foundations, however, the deduction is limited to 20 percent of the taxpayer's adjusted gross income. In addition, in limited circumstances, a taxpayer may be allowed an unlimited charitable contributions deduction.

General reasons for change.—In order to strengthen the incentive effect of the charitable contributions deduction for taxpayers, the committee's bill generally increases the present 30-percent limitation to 50 percent. The committee believes this change is particularly desirable in view of the repeal of the unlimited charitable contributions deduction (see No. 2 below). It is believed that the increase in the limitation will benefit taxpayers who donate substantial portions of their income to charity and for whom the incentive effect of the deduction is strong—primarily taxpayers in the middle- and upper-income ranges. In addition, the combination of the increase in the limitation to 50 percent with the repeal of the unlimited charitable deduction means, in effect, that charity can remain an equal partner with respect to an individual's income; however, charitable contributions no longer will be allowed to reduce an individual's tax base by more than one-half.

Explanation of provision.—Both the House bill and the committee amendments generally increase the limitation on the charitable contributions deduction for individual taxpayers from 30 percent of adjusted gross income to 50 percent. However, the 50 percent limit is generally not to be available with respect to the appreciation in value in gifts of property. The committee amendments make three modifications in the House bill.

First, the committee amendments provide that a taxpayer's cost or other basis for property contributed to public charities is to be eligible for the 50 percent limitation, and that only the appreciation element in the donated property is to be limited to 30 percent. Under the House bill, the entire value of the gift of appreciated property would have been limited to 30 percent. The committee believes this modification is appropriate since the rule in the House bill would deny the additional 20 percent charitable deduction even though the appreciation element in a contribution may be quite small.

Second, the provision of the House bill which retained the general limitation of 30 percent with respect to the charitable contributions deduction in the case of gifts to certain private foundations has been altered by the committee. Under the committee amendments contributions to private operating foundations, and also private nonoperating foundations which distribute the contributions they receive to public charities or private operating foundations within 1 year following the year of receipt, are to qualify for the 50-percent limitation (30 percent as to the appreciation element). Under the House bill, contributions to these organizations would only have been eligible for the 20-percent limitation. The committee amendments will treat these two types of private foundations the same as public charities for purposes of the limitations, and the committee believes it will simplify the application of these limitations.

Third, the House bill provides that the percentage limitations are to be applied to a taxpayer's adjusted gross income plus the amount of tax preferences not included in the tax base. The committee amendments restore existing law and base the percentage limitations on a taxpayer's adjusted gross income.

Effective date.—The increase in the limit on the deductibility of contributions from 30 percent to 50 percent (including the change respecting private operating and nonoperating foundations), and the modification limiting the deduction with respect to the appreciation element in donated property (to 30 percent), are applicable with respect to contributions paid in taxable years beginning after December 31, 1969.

2. Repeal of the Unlimited Charitable Deduction (sec. 201(a) of the bill and sec. 170(b)(1)(C), (f)(6), and (g) of the code)

Present law.—Under present law, the charitable contributions deduction for individuals generally is limited to 30 percent of the taxpayer's adjusted gross income. In the case of gifts to private foundations not receiving a substantial part of their support from a governmental unit or the general public, the limitation is 20 percent.

An exception to this general limitation allows a taxpayer an unlimited charitable contribution deduction, if in 8 out of 10 preceding taxable years the total of the taxpayer's charitable contributions plus income taxes exceeded 90 percent of his taxable income (computed without regard to the charitable contributions deduction, personal exemptions, and net operating loss carrybacks).

General reasons for change.—The committee's attention was called to the fact that the unlimited charitable contributions deduction has allowed a small number of high-income persons to pay little or no tax on their income. It has been indicated that the unlimited charitable deduction currently is used by about 100 taxpayers who generally have economic incomes well in excess of $1 million. Moreover, it appears that the charitable contributions deduction is one of the most important itemized deductions used by high-income taxpayers, who pay little or no tax, to reduce their tax liability.

The committee does not believe that high-income taxpayers should be allowed to significantly minimize or completely avoid tax liability by means of the charitable contribution deduction. Accordingly, the committee agrees with the House that the unlimited charitable contion with the increase should be repealed. The effect of this, in combination with the increase in the general limitation on the deduction from 30 percent to 50 percent (as described in No. 1 above), is that charity can remain an equal partner with respect to an individual's income, but the charitable contributions deduction no longer will be allowed to reduce an individual's adjusted gross income by more than one-half.

In view of the fact that it takes a number of years for a taxpayer to qualify for the unlimited deduction, however, the committee believes it is desirable to remove the unlimited charitable deduction after a 5-year transition period during which the extra charitable deduction is ratably phased down to the general limit, rather than eliminating it abruptly.

Explanation of provision.—For the reasons discussed above, both the House and the committee versions of the bill provide that the unlimited charitable contribution deduction is to be completely eliminated for years beginning after 1974. During the interim period, an increasing limitation is to be placed on the extent to which the so-called unlimited charitable deduction can reduce an individual's taxable income. For taxable years beginning in 1970, this charitable deduction is not to reduce a taxpayer's taxable income to less than 20 percent of his adjusted gross income. This percentage is to be increased ratably by 6 percentage points a year for the years 1971 through 1974 until the limit on the deduction finally reaches the general 50-percent limit for 1975 and thereafter.

To take account of the increasing limitation on the charitable deduction, the bill also provides that the percentage of the taxpayer's taxable income which must be given to charity (or paid in income taxes) in 8 out of the 10 preceding taxable years in order to qualify for the extra charitable deduction is to be reduced to 80 percent for taxable years beginning in 1970, and is then to be reduced by 6 percentage points a year for subsequent taxable years beginning in 1971 through 1974.

In addition to the above provisions, the committee amendments provide that, during the interim period through 1974, the 30-percent limit on gifts of appreciated property and the appreciated property rule which takes the appreciation into account for tax purposes in the case of property which would give rise to a long-term capital gain if sold are not to apply in the case of a person qualifying for the extra charitable contribution deduction (above the general 50-percent limit).

Effective date.—This provision is to apply with respect to contributions made in taxable years beginning after December 31, 1969.

3. Charitable Contributions of Appreciated Property (sec. 201(a) of the bill and sec. 170(e) of the code)

Present law.—Under present law, a taxpayer who contributes property which has appreciated in value to charity generally is allowed a charitable contributions deduction for the fair market value of the property and no tax is imposed on the appreciation in value of the property. A special rule (sec. 170(e)) applies, however, to gifts of certain property so that the amount of charitable contribution is reduced by the amount of gain which would have been treated as ordinary income under the recapture rules for certain mining property (sec. 617), depreciable tangible personal property (sec. 1245) and certain depreciable real property (sec. 1250), if the property contributed had been sold at its fair market value.

If property is sold to a charity at a price below its fair market value—a so-called bargain sale—the proceeds of the sale are considered to be a return of the cost and are not required to be allocated between the cost basis of the "sale" part of the transaction and the "gift" part of the transaction. The seller is allowed a charitable contributions deduction for the difference between the fair market value of the property and the selling price (often at his cost or other basis).

General reasons for change.—The combined effect, in the case of charitable gifts of appreciated property, of allowing a charitable contributions deduction for the fair market value (including the appreciation) and at the same time not taxing the appreciation, is to produce tax benefits significantly greater than those available with respect to cash contributions. The tax saving which results from not taxing the appreciation in the case of gifts of capital assets is the otherwise applicable capital gains tax which would be paid if the asset were sold. In the case of gifts of ordinary income property, however, this tax saving is at the taxpayer's top marginal income tax rate. In either case, this tax saving is combined with the tax saving of the charitable deduction at the taxpayer's top marginal rate.

Thus, in some cases it actually is possible for a taxpayer to realize a greater after-tax profit by making a gift of appreciated property than by selling the property, paying the tax on the gain, and keeping the proceeds. This is true in the case of gifts of appreciated property which would result in ordinary income if sold, when the taxpayer is at the high marginal tax brackets and the cost basis for the ordinary income property is not a substantial percentage of the fair market value. For example, a taxpayer in the 70-percent tax bracket could make a gift of $100 of inventory ($50 cost basis) and save $105 in taxes (70 percent of the $50 gain if sold, or $35, plus 70 percent of the $100 fair market value of the inventory, or $70).

The committee does not believe that the charitable contributions deduction was intended to provide greater—or even nearly as great—tax benefits in the case of gifts of property than would be realized if the property were sold and the proceeds were retained by the taxpayer. In cases where the tax saving is so large, it is not clear how much charitable motivation actually remains. It appears that the Government, in fact, is almost the sole contributor to the charity. Moreover, an unwarranted tax benefit is allowed these taxpayers, who usually are in the very high income brackets. The committee, therefore, considers it appropriate to narrow the application of the tax advantages in the case of gifts of certain appreciated property.

Explanation of provision.—The House bill takes appreciation into account for tax purposes in five types of situations. The committee amendments retain two of these provisions.

Both the House bill and the committee amendments provide that appreciation is to be taken into account for tax puposes in the case of gifts to a private foundation, other than an operating foundation and other than a private foundation which within one year distributes an amount equivalent to the gift to public charitable organizations or private operating foundations. In addition, both the House bill and the committee amendments take appreciation in value into account for tax purposes in the case of property (such as inventory or works of art created by the donor) which would give rise to ordinary income if sold.

In the case where the appreciation is taken into account for tax purposes, the committee amendments provide that the charitable deduction otherwise available is to be reduced by the amount of appreciation in value in the case of assets which if sold would result in ordinary income, or in the case of assets which if sold would result in capital gain, by 50 percent (62½ percent for corporations) of the amount of this appreciation in value. The House bill would have given the taxpayer the option of reducing his charitable deduction to the amount of his cost or other basis for the property, or of including the appreciation in value of the property in his income (as ordinary income or capital gains income as the case may be) at the time of taking the charitable contribution deduction and deducting the full fair market value of the property as a charitable contribution.

Examples of the types of property giving rise to ordinary income where either some, or all, of the appreciation is to be taken into account without regard to the type of charitable recipient are gifts of inventory, "section 306 stock" (stock acquired in a non-taxable transaction which is treated as ordinary income if sold), letters, memorandums, etc., given by the person who prepared them (or by the person for whom they were prepared), and stock held for less than 6 months. Under the committee amendments, the portion of the appreciation taken into account in these cases is the amount which would be treated as ordinary income if the property were sold. This would be all of the appreciation in the case of gifts of inventory but in the case of gifts of depreciable tangible personal property used in the trade or business of the taxpayer, for example, it would be only the portion of the gain subject to recapture (under sec. 1245) since any remaining gain above this amount would still be treated as a capital gain not taken into account by this provision (unless the contribution were to certain private foundations). Under the House provision, it appears that the full appreciation would have been taken into account if any of the gain would (if sold) have been taxed as ordinary income.

Appreciation is also to be taken into account for tax purposes in the case of gifts of appreciated property (regardless of whether it is ordinary income property or long-term capital gains property) to private foundations, other than private operating foundations and other than private nonoperating foundations which within 1 year after the taxable year in which the gift is received distributes an equivalent amount to "public" charitable organizations or private operating foundations. The private nonoperating foundation, to comply with the one-year payment requirement, must distribute this amount in addition to distributing all of its income or an amount equal to the 5 percent payout requirement, whichever is higher.

The committee deleted the other types of situations covered in the House bill which would have taken the appreciation in value into account for tax purposes in gifts of appreciated property: gifts of future interests in property, gifts of tangible personal property, and the so-called bargain sale to charity.

In the case of future interests in property, the committee believed that inclusion of such property in the appreciated property rules could have a substantial adverse impact on charitable giving to public charities and schools, since this type of giving often may take the form of a future interest(such as the case of a remainder interest in trust).

The committee considers it appropriate to treat gifts of tangible personal property (such as paintings, art objects, and books not produced by the donor) to public charities and schools similarly to gifts of intangible personal property and real property. Moreover, the committee believes that the serious problems of valuation of gifts of tangible personal property would still remain even if the appreciation were to be taken into account for tax purposes, and that a more desirable method of controlling overvaluations is for the Internal Revenue Service to strengthen its audit procedures for reviewing the value claimed on such gifts. Special consideration is warranted even in the case of smaller contributions than those which presently are closely reviewed by the Commissioner's advisory panel on valuation of art objects.

In the case of the so-called bargain sales to charity—where a taxpayer sells property to a charitable organization for less than its fair market value (often at its cost basis)—the committee believes that the House provision would adversely affect giving to charities, as "bargain sales" have been a long-accepted form of making contributions of property to charities.

Effective dates.—The amendments made by this provision relating to gifts of certain appreciated property generally are to apply with respect to contributions paid after December 31, 1969. However, in the case of a contribution of a letter, memorandum, or similar property (to which sec. 514 of the bill applies), the amendments apply to such contributions made after December 31, 1968.

4. Repeal of 2-year Charitable Trust Rule (sec. 201(c) of the bill and sec. 673(b) of the code)

Present law.—Under present law, an individual may establish a trust for two years or more with income from the property he transfers to the trust being payable to charity for a period of at least 2 years. After the two years or more the property is returned to him. Although the individual does not receive a charitable contributions deduction in such a case, the income from the trust property is not taxed to the individual. This 2-year charitable trust rule is an exception to the general rule that the income of a trust is taxable to a person who establishes the trust where he has a reversionary interest in the trust which will or may be expected to take effect within 10 years.

General reasons for change.—The effect of the special 2-year charitable trust rule is to permit charitable contributions deductions in excess of the generally applicable percentage limitations of such deductions. For example, with the 50-percent limitation on such deductions contained in the committee amendments and the House bill, the maximum deductible contribution that could generally be made each year by an individual who had $100,000 of dividend income (but no other income) would be $50,000. However, if the individual transferred 70 percent of his stock to a trust with directions to pay the annual income ($70,000) to charity for 2 years and then return the property to him, the taxpayer excludes the $70,000 from his own income each year. In effect, the individual has received a charitable contribution deduction equal to 70 percent of his income.

The committee agrees with the House that taxpayers should not be allowed to avoid the limitations on the charitable contribution deduction by means of a 2-year charitable trust.

Explanation of provision.—In order to eliminate the above-described means of avoiding the generally applicable percentage limitations on the charitable contribution deduction, both the House bill and the committee amendments repeal the 2-year trust provision (sec. 673(b)). Accordingly, an individual no longer is to be able to exclude the income from property placed in a trust to pay the income to a charity for a period of at least 2 years from his income. As a result, a person who establishes a trust will be taxable on its income, whether or not the income beneficiary is a charity, where the individual has a reversionary interest which will or may be expected to take effect within 10 years from the time the income-producing property is transferred to the trust.

Effective date.—This provision is to apply with respect to transfers in trust made after April 22, 1969.

5. Gifts of the Use of Property (sec. 201(a) of the bill and sec. 170(f)(3) of the code)

Present law.—Under existing law, a taxpayer may claim a charitable deduction for the fair-rental value of property which he owns and gives to a charity to use for a specified time. In addition, he may exclude from his income the income which he would have received and been required to include in his tax base had the property been rented to other parties.

General reasons for change.—An individual receives what may be described as a double benefit by giving a charity the right to use property which he owns for a given period of time. For example, if the individual owns an office building, he may donate the use of 10 percent of its rental space to a charity for 1 year. As a result, he will report for tax purposes only 90 percent of the income which he otherwise would have had if the building were fully rented, and still may claim a charitable deduction (amounting to 10 percent of the rental value of the building) which offsets his already reduced rental income.

Explanation of provision.—The committee retained the basic House provision and, in effect, provided that a charitable deduction is not to be allowed for contributions to charity of less than the taxpayer's entire interest in property, except to the extent a deduction would be allowed had the interest been transferred in trust. Therefore, no deduction is to be allowed where a contribution is made of the right to use property for a period of time. In such a case, however, the taxpayer is able to continue to exclude from his income the value of the right to use the property contributed to the charity.

The committee modified the House bill, however, to insure that it will not result in the denial of a deduction where an outright gift is made of an undivided (e.g., one-fourth) interest in property.

Effective date.—The committee amendments apply to gifts made after October 9, 1969. The House bill would have applied with respect to gifts made after April 22, 1969.

6. Charitable Contributions by Estates and Trusts (sec. 201(b) of the bill and sec. 642(c) of the code)

Present law.—Under present law, a nonexempt trust (or estate) is allowed a full deduction for any amount of its gross income which it pays or which it permanently sets aside for charitable purposes. There is no limitation on the amount of this deduction.

General reasons for change.—The House bill eliminated the deduction presently allowed trusts and estates for amounts set aside for (rather than paid to) charity. The committee is in general agreement with the House that the retention of the set-aside deduction for nonexempt trusts would be inconsistent with other changes made by the bill in the treatment of foundations and charitable trusts. Nonexempt trusts generally are subject to the same requirements and restrictions imposed on private foundations, since to the extent of the charitable interest, their use achieves the same result. The current income distribution requirement generally applicable to foundations is not imposed on these nonexempt trusts, however, but the same result is achieved by denying the set-aside deduction to these trusts for their current income. In other words, to obtain the charitable deduction the nonexempt trusts must pay out their income currently for charity much in the same manner as private foundations are required to do.

In the case of a charitable remainder trust (i.e., a trust which provides that the income is to be paid to a noncharitable beneficiary for a period of time and the remainder interest is to go to charity), the bill provides that if specified requirements are met, the trust is to be tax exempt. These requirements are designed to limit the allowance of a charitable deduction for the remainder interest upon creation of the trust to situations where there is a reasonable correlation between the amount of the deduction and the benefits that the charity will ultimately receive. Where these requirements are met, and the trust is thus accorded tax-exempt status, there is no need to allow the trust a deduction for amounts set aside for charity. To accord nonexempt trusts (with a remainder interest for charity) consistent treatment, it is necessary to deny them a deduction for amounts set aside for charity.

In the case of estates, however, the committee does not believe it is appropriate to eliminate the set-aside deduction as is done in the House bill. There are safeguards in the case of estate administration which are not usually present during trust administration and, in addition, it often may be impractical or contrary to probate law for an estate to make current distributions of amounts to charity.

The committee also believes that to a limited extent the set-aside deduction should continue to be available for pooled income arrangements under which a person transfers property to a public charity which then places the property in an investment pool and pays the donor (and perhaps another person) the income attributable to the property for life. Pooled income arrangements have been increasingly relied upon by public charities as a means of obtaining charitable contributions. Thus, the complete removal of the set-aside deduction, which allows the pooled income arrangement to accumulate capital gains for the benefit of charity without tax, could have a significant adverse effect on the use of these arrangements and on charitable giving.

Explanation of provision.—For the reasons discussed above, the House bill and the committee amendments eliminate the so-called set-aside deduction presently allowed trusts. However, a nonexempt trust will still be allowed in computing its taxable income to deduct any amount of its gross income, without limitation, paid as a charitable contribution. In addition, to enable the trustee to act after he knows the income for the year precisely, a trustee may make a contribution in the next following taxable year and elect to treat such contribution as made during the taxable year. As under existing law, proper adjustment is to be made for charitable contributions paid out of capital gain income and the deduction is not to diminish the unrelated business income of the trust, if any. These rules of existing law also are applicable in cases where the set-aside deduction continues to be available.

Under the committee amendments, estates are to continue to receive the set-aside deduction presently allowed.

In the case of pooled income funds, the committee amendments also provide that the fund is to be allowed to deduct amounts set aside for charitable purposes to the extent of the fund's long-term capital-gain income. Generally, a pooled income fund is a trust to which a person has transferred property giving an irrevocable remainder interest in the property to a public charity and retaining an income interest in the property for the life of one or more beneficiaries living at the time of the transfer. The fund must commingle the property transferred to it with property transferred to it under similar circumstances by other persons. It is further provided that the fund may have no investments in tax-exempt securities, that no donor or income beneficiary may be a trustee of the fund, and that the fund must be maintained by the charitable organization to which the remainder interest is given. No donor or beneficiary of an income interest may be a trustee. It is not necessary, however, for the charitable organization to be the trustee of the fund. Each person who has a life income interest as a result of a transfer of property to the pooled income fund must receive an amount of income each year which is determined with reference to the trust's rate of return for the year. A pooled income fund will not qualify under this provision if it includes amounts received under types of arrangements other than those described above.

The termination of the set-aside deduction provided by the House bill in the case of trusts would be applied tc existing trusts as well as trusts established in the future. The committee, however, does not believe it is appropriate to terminate the set-aside deduction presently allowed existing arrangements which were previously established in contemplation that the set-aside deduction could continue to be available and which cannot be modified to take the new rules into account. Accordingly, the committee amendments provide that the set-aside deduction is to continue to be available for a trust established before October 10, 1969, which is required by the terms of its governing instrument to set-aside amounts, either if an irrevocable remainder interest in the trust was given to charity or if the trust could not be modified at any time after October 9, 1969, because the grantor was under a mental disability to change its terms at all times after that date. The set-aside deduction is to continue to be available in these cases, however, only to the extent of income earned on amounts transferred to the trust prior to October 9, 1969.

The set-aside deduction also is to continue to be available under the committee amendments in the case of a trust established by a will in existence on October 9, 1969, which the testator could not modify prior to his death either because he was under a mental disability on that date and at all times thereafter or because he did not have the right at any time after that date to change the will as it relates to the trust. It also appears appropriate to allow a reasonable time for amendment of existing wills which provide for a trust that is to set aside amounts for charity to take the unavailability of the set-aside deduction provided by the bill into account. Accordingly, it is provided that the set-aside deduction is to continue to be available in the case of trusts established by a will in existence on October 9, 1969, if the testator dies within 3 years (i.e., before October 9, 1972) without having republished the will. The set-aside deduction is to continue to be available in these cases, however, only if the governing instrument of the trust requires it to set aside amounts and only to the extent of income earned by the trust on amounts transferred to it under the will establishing it.

Effective date.—The House bill provided that the changes made by this provision were to apply to amounts paid for a charitable purpose after the date of enactment of the bill. Under the committee amendment this provision is to apply to amounts paid or set aside after December 31, 1969.

7. Charitable Remainder Trusts (sec. 201(a), (d), and (e) of the bill and secs. 170(f), 664, 2055(e), 2106(a), and 2522(c) of the code)

Present law.—Under present law, an individual may make an indirect charitable contribution by transferring property to a trust and providing that the income is to be paid to private persons for a period of time with the remainder to go to a charity. A charitable contributions deduction generally is available for the remainder interest given to charity. The amount of the deduction is based on the present value of the remainder interest which is determined by using actuarial life expectancy tables and an assumed interest rate.

Under existing law and regulations, the assumed interest rate is 3½ percent. In other words, it is assumed that there will be a 3½ percent income return on trust assets. Moreover, the 3½ percent rate is also used to determine the present value of the income and remainder interests.

General reasons for change.—The rules of present law for determining the amount of a charitable contribution deduction in the case of gifts of remainder interests in trust do not necessarily have any relation to the value of the benefit which the charity receives. This is because the trust assets may be invested in a manner so as to maximize the income interest with the result that there is little relation between the interest assumptions used in calculating present values and the amount received by the charity. For example, the trust corpus can be invested in high-income, high-risk assets. This enhances the value of the income interest but decreases the value of the charity's remainder interest.

The committee agrees with the House that a taxpayer should not be allowed to obtain a charitable contribution deduction for a gift of a remainder interest in trust to a charity which is substantially in excess of the amount the charity may ultimately receive. To provide a closer correlation between the charitable contributions deduction and the ultimate benefit to charity, the House bill generally provided that a deduction would not be allowed for a gift of a remainder interest in trust to charity unless the gift took a specified form: namely, an annuity trust (under which the income beneficiary is to receive a stated dollar amount annually) or a unitrust (under which the income beneficiary is to receive an annual payment based on a fixed percentage of the trust's assets). Another provision of the bill (see No. 5 above) denied a deduction for an outright gift of a remainder interest to charity except to the extent a deduction would have been allowed if the gift had been in trust. This had the effect of denying a charitable contributions deduction in the case of a nontrust gift of a remainder interest to charity.

Although, as indicated above, the committee is in general agreement with the House regarding the need for a closer correlation between the charitable contributions deduction allowed for a gift of a remainder interest to charity and the benefit ultimately received by the charity, the committee believes that the House provision is unduly restrictive. The requirement that a deduction is to be allowed only if the remainder interest given to charity is in the form of an annuity trust or unitrust could have a significant adverse effect on established forms of charitable giving, such as pooled income fund arrangements, and outright gifts of real property, such as a residence, where the donor reserves a life estate in the property. Since these types of charitable giving cannot be framed in the form of an annuity trust or unitrust, the House provision would deny a deduction for the charitable gift. The committee believes that it is possible to continue to allow a charitable deduction in these types of cases with appropriate limitations, however, to prevent the overstating of the charitable contribution deduction.

The committee also believes that the annuity trust and unitrust rules provided by the House bill should be modified to allow greater flexibility in the case of charitable gifts in this form. The committee believes this can be done in such a manner as to prevent the manipulation of the trust assets to the detriment of the charitable remainder interest.

The committee's attention also was called to the fact that in some cases charitable contribution deductions have been allowed for gifts of charitable remainder interests in trust even though it is likely that the gift will not ultimately be received by the charity. An example of this is a situation where the charity has only a contingent remainder interest in the trust (for example, a $5,000 annuity to A for life, remainder to his children, or to a charity if A has no children). Another example is the situation where a charity has a remainder interest and the trust permits invasion of the charitable share for the benefit of a noncharitable intervening interest which is incapable of reasonably certain actuarial valuation (for example, a $5,000 annuity to A for life, remainder to a charity, but the trust provides that the trustee may pay A amounts in excess of $5,000 in order to maintain his standard of living).

It is the committee's understanding that a charitable contribution deduction for income tax purposes would not be allowed in these situations if the probability of the charity receiving the specified interest were determined under the rules presently applied in the case of the estate tax. The committee believes that uncertain invasions of corpus should not be possible if an income tax deduction is to be allowed.

Explanation of provision.—For the reasons discussed above, the committee amendments provide limitations (for income tax, gift tax, and estate tax purposes) on the allowance of a charitable contribution deduction for a charitable gift of a remainder interest. As under the House bill, a deduction is to be allowed for a charitable gift of a remainder interest in trust, where there is a noncharitable income beneficiary, if the trust is either a charitable remainder annuity trust or a charitable remainder unitrust. The committee agrees with the House that this requirement will provide a better means of assuring that the amount received by the charity will accord with the charitable deduction allowed to the donor on creation of the trust. This is because the requirement will remove the present incentive to favor the income beneficiary over the remainder beneficiary by means of manipulating the trust's investments. The amount received each year by the income beneficiary, generally, will have to be either a stated dollar amount or a fixed percentage of the value of the trust property.

In addition, under the committee amendment a deduction is to be allowed for a gift of a charitable remainder interest in trust which takes the form of a transfer of property to a pooled income fund. (The definition of a pooled income fund is discussed in No. 6 above.) In order to prevent manipulation to overstate the appropriate charitable contribution deduction in the case of this type of gift, it is further provided that the amount of the charitable contribution deduction allowed the donor upon the transfer of property to the pooled income fund is to be determined by valuing the income interest on the basis of the highest rate of return earned by the particular pooled income fund in any of the three taxable years preceding the taxable year of the fund in which the transfer occurs. Where a fund has not been in existence for this period of time, the rate of return is to be assumed to be 6 percent, unless a different rate is prescribed by the Secretary of the Treasury or his delegate.

Another additional situation in which the committee amendments allow a charitable contribution deduction for the gift of a remainder interest to charity is in the case of a nontrust gift of a remainder interest in real property to charity. Thus, for example, a charitable contribution deduction is to be allowed where an individual makes a gift of his residence to charity and retains the right to live in the residence for his life. The committee does not believe that this type of situation generally presents the kind of abuse which both the House and the committee believe it appropriate to curtail.

Nevertheless, a limited valuation problem is presented even in this type of situation, and for this reason it is further provided that in determining the value of a remainder interest in real property which is given to charity, straight-line depreciation and cost depletion are to be taken into account. Thus, there will be an appropriate reflection in the value of the charitable gift of the decrease in value of the property which may occur as a result of the depreciation or depletion of the property. In addition, the committee contemplates that the Secretary of the Treasury or his delegate will provide that the rate of return to be used in valuing this type of charitable gift is one which is reasonable in view of the interest rates and investment returns prevailing at the time of the gift. At the present time, a 6 percent rate of return would appear appropriate to the committee.

As indicated above, the committee has retained with minor modifications the annuity trust and unitrust rules of the House bill. Under the House provision, an annuity trust is one which specifies in dollar terms the amount of the annuity which is to be paid to the income beneficiary. The trust also must require the income payments to be made at least annually. A unitrust is a trust which specifies that the income beneficiary is to receive annual payments based on a fixed percentage of the net fair market value of the trust's assets, as determined each year. The income interest in either case may either be for a term of years or for the life of the income beneficiary.

The committee amendments retain these definitions with the following modifications. First, the committee amendments allows a charitable remainder annuity trust or unitrust to provide that when the trust income is less than the required payment to the noncharitable income beneficiary, the trust only has to distribute to the income beneficiary the amount of the trust income. In addition, the deficiencies in income distributions (i.e., where the trust income was less than the stated amount payable to the income beneficiary) could be made up in later years when the trust income exceeded the amount otherwise payable to the income beneficiary for that year. For purposes of this provision, the determination of what constitutes trust income is to be made under the applicable local law and, thus, is not to include items such as capital gains which must be allocated to the trust principal.

A second modification of the annuity trust and unitrust rules made by the committee provides that the charitable remainder trust must be required by the trust instrument to distribute each year 5 percent of the net fair market value of its assets (valued annually in the case of a unitrust and valued at the time of the contribution in the case of an annuity trust) or the amount of the trust income, whichever is lower. In valuing the amount of a charitable contributions deduction in the case of a remainder interest given to charity in the form of an annuity trust or a unitrust, it is to be computed on the basis that the income beneficiary of the trust will receive each year the higher of 5 percent of the net fair market value of the trust assets or the payment provided for in the trust instrument. In addition, the committee amendments clarify the fact that an annuity trust or unitrust may not provide for payments to the noncharitable income beneficiaries of amounts other than the stated annuity or fixed percentage amount.

The committee believes that the combination of these additional rules will allow greater flexibility in the making of charitable gifts in the form of remainder interests in trust but at the same time will adequately protect against abuse. Allowing a charitable remainder trust to distribute to the income beneficiary the lesser of the trust income or the stated payout will prevent a trust from having to invade its corpus when the income for a year is below that originally contemplated.

On the other hand, requiring a charitable remainder trust to distribute currently at least the amount of its income (other than long-term capital gains), if this is less than a 5 percent payout and the requirement that the charitable remainder interest be valued by assuming at least a 5 percent payout to the income beneficiary will prevent a charitable remainder trust from being used to circumvent the current income distribution requirement imposed on private foundations. In the absence of these rules, a charitable remainder trust could be established which provided for a minimal payout to the noncharitable income beneficiary (substantially less than the amount of the trust income). Since the trust generally is exempt from income taxes this would allow it to accumulate trust income in excess of the payout requirement of the unitrust or annuity trust without tax for the future benefit of charity.

The committee has modified the House provision to make it clear an annuity trust or a unitrust may have more than one noncharitable income beneficiary, if the interest of each such beneficiary either is for a term of years which does not exceed 20 years or is for the life of the beneficiary. An individual who is not living at the time of creation of the trust, however, may not be an income beneficiary of a charitable remainder trust.

Under either an annuity trust or a unitrust, an amount paid to the income beneficiary is to be treated as consisting of the following amounts: First, ordinary income to the extent of the trust's ordinary income for the taxable year and its undistributed ordinary income from prior years; second, as a capital gain to the extent of the trust's capital gains for the taxable year and its undistributed capital gains (determined on a cumulative net basis) for prior years; third, as other income (such as non-taxable income) to the extent of the trust's other income for the year and its undistributed other income from prior years; and finally, as a distribution of corpus.

Under the House bill, a charitable remainder trust which qualified as an annuity trust or a unitrust would be exempt from income taxation. The committee amendments modify this provision so as to deny the exemption from tax for any year in which the trust has income which would be unrelated business taxable income if the trust were an exempt organization subject to the unrelated business income tax. The committee does not believe that it is appropriate to allow the unrelated business income tax to be avoided by the use of a charitable remainder trust rather than a tax-exempt organization.

Effective date.—The House bill provided that this provision was to be effective with respect to transfers in trust after April 22, 1969, for income tax purposes, and with respect to gifts made after April 22, 1969, for gift tax purposes. Under the committee amendments, this provision is to be effective with respect to transfers in trust after October 9, 1969, and to gifts made after that date, for income tax and gift tax purposes, respectively.

In the case of the estate tax, the House bill provided that this provision was to apply with respect to decedents dying after the date of enactment of the bill.

The committee does not believe it is appropriate to make the new rules applicable to existing arrangements which were established under today's law and which cannot be modified to take the new rules into account. Accordingly, the committee amendments provide that the new rules are not to apply for estate tax purpose in the case of property transferred in trust before October 10, 1969, in which an irrevocable remainder interest was given to charity. In addition, the new rules are not to apply in the case of property passing under a will in existence on October 9, 1969, or property transferred in trust on or before that date, if the will or trust was not modified by the individual prior to October 9, 1972, and could not be modified thereafter by the decedent because he was under a mental disability on that date and at all times thereafter. It also is provided that the new rules are not to apply to property passing under a will in existence on October 9, 1969, where the individual did not have at any time thereafter the right to change the will as it relates to the charitable gift.

The committee also believes that it is appropriate to allow a reasonable period of time for existing wills and existing trusts to be modified to take the new rules into account. Accordingly, it is provided that the new rules are not to apply to property passing under a will in existence on October 9, 1969, or to property transferred in trust on or before October 9, 1969, if the individual dies within three years (i.e., before October 9, 1972) without having modified the will or the trust.

8. Charitable Income Trust With Noncharitable Remainder (sec. 201 (a) and (d) of the bill and secs. 170(f), 2055(e), 2106(a), and 2522(c) of the code)

Present law.—Under present law, a taxpayer who transfers property to a trust to pay the income to a charity for a period of years with the remainder to go to a noncharitable beneficiary, such as a friend or members of his family, is allowed a charitable contribution deduction for the present value of the income interest given to the charity. In addition, neither he nor the trust is taxed on the income earned by the trust.

Present law also provides that a charitable contribution deduction for a gift of an income interest in trust to a charity is not to be allowed where the grantor retains a substantial (over 5 percent) reversionary interest in the trust. A grantor who retains a reversionary interest in a trust is taxed on the income earned by the trust, if his reversionary interest will or may be reasonably expected to take effect within 10 years from the time of the transfer to the trust.

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General reasons for change.—A taxpayer receives a double tax benefit where he is allowed a charitable contribution deduction for the present value of an income interest in trust given to charity and also is not taxed on the income earned by the trust. Thus, a taxpayer may give an income interest to charity for any period of time followed by a remainder interest to a noncharitable beneficiary, such as his son, and obtain a deduction for the present value of the income interest while at the same time excluding the income from his own income. This double benefit allows a taxpayer to increase his after tax cash position by postponing a planned noncharitable gift.

For example, assume a taxpayer in the 70-percent bracket transferred property worth $100,000 currently earning interest at the rate of 5 percent to a trust for 2 years specifying that $5,000 be paid to charity each year, remainder to A. If the taxpayer had retained the property for 2 years he would have received $10,000 in interest taxable at 70 percent for an aftertax return of $3,000. On the other hand, by transferring the property to a trust he received a charitable deduction of $9,498.50 (the present value of the charitable interest). The $10,000 received by the charity is not included in income and the deduction claimed reduces his tax on other income by $6,648.95.

The committee agrees with the House that this double benefit is an unwarranted tax advantage which is not a necessary inducement to charitable giving. A charitable contribution deduction should not be allowed for an income interest given to charity in trust in circumstances where the trust income is not taxed to the taxpayer.

The House bill also provided, however, that the charitable deduction for gift tax purposes in this case was to be denied to the extent it was denied for income tax purposes and further provided that no charitable deduction was to be allowed in this case for estate tax purposes. It does not appear to the committee that the rationale for the denial of the deduction in the case of the income tax charitable deduction (i.e., the prevention of a double benefit) is applicable in the case of the gift tax or the estate tax. Accordingly, the committee has modified the House bill so as to allow a charitable deduction for estate and gift tax purposes for a gift of a charitable income interest in trust, if the requirements of the House bill as to the form of the gift are met.

Explanation of provision.—Both versions of the bill provide that for income tax purposes a charitable contribution deduction is not to be allowed for an income interest given to charity in trust, unless the grantor is taxable on the income of the trust or unless all the interests in the trust are given to charity. The bill also provides that a charitable deduction is not to be allowed for income tax purposes for an income interest given to charity in trust unless either the interest is in the form of a guaranteed annuity or the trust instrument specifies that the charitable-income beneficiary is to receive a fixed percentage annually of the fair market value of the trust property (as determined each year).

The effect of this is to deny the double benefit of a deduction and exemption from taxation which is available under present law. In addition, this will allow a taxpayer to receive a charitable contribution deduction where the income from the trust is taxed to him, notwithstanding the fact that he retains a substantial reversionary interest in the trust (which under present law would not be allowed). The bill also provides that in a case where a deduction is allowed for an income interest given to a charity, the grantor is not to be allowed an additional deduction for the amount of any contribution made by the trust with respect to the income interest.

The purpose of the unitrust-annuity trust requirement is to assure that the amount received by the charity, in fact, bears a reasonable correlation to the amount of the charitable contribution deduction allowed the taxpayer. Under the committee amendments, the requirement that the grantor be taxable on the income of the trust is not applicable for estate and gift tax purposes but the unitrust-annuity trust requirement is applicable in determining whether the income interest qualifies as an estate or gift tax charitable contribution deduction. Under the House bill, this latter rule would have been applied only for income and gift tax purposes. (As indicated above, the House bill did not allow an estate tax charitable deduction for a gift of an income interest to charity in trust.)

If a taxpayer who was allowed a charitable deduction for income tax purposes under the above rules for an income interest transferred in trust to charity subsequently ceased to be taxable on the trust income, he would receive a double tax benefit with respect to the future trust income—he would not be taxed on that income but would have received a charitable deduction with respect to it. To prevent this result, both versions of the bill, in effect, provide for the recapture of that part of the charitable contribution deduction previously received by the taxpayer with respect to the income of the trust which will go to the charity but on which he will not be taxed. This is accomplished by treating the donor at the time he ceases to be taxable on the trust income as having received income to the extent the deduction he previously was allowed exceeds the value of the income previously earned by the trust and taxable to him. For this purpose, these amounts of income are to be discounted to their value at the time of the contribution to the trust.

Effective date.—Under the House bill this provision was to apply for income and gift tax purposes with respect to transfers of property to a trust after April 22, 1969. The committee amendments provide that this provision is to apply for these purposes with respect to transfers of property to a trust after October 9, 1969. For estate tax purposes, the effective dates of this provision are the same as those discussed in No. 7 above.

9. Limitations on Nonexempt Trusts (sec. 101 of the bill and secs. 508 and 4947 of the code)

Present law.—Present law does not impose restrictions or requirements on nonexempt trusts which are similar to those which would be imposed by the bill on private foundations. In addition, the allowability of a charitable contributions deduction (for income, gift, and estate tax purposes) for a gift to charity in the form of an interest in trust is not conditioned on the existence of provisions in the trust instrument which prevent the trust from violating restrictions or requirements of this nature.

General reasons for change.—If a nonexempt charitable trust were not subject to many of the requirements and restrictions imposed on private foundations, it would be possible for taxpayers to avoid these restrictions by the use of nonexempt trusts instead of private foundations. To forestall this possibility, the House bill generally imposed on nonexempt charitable trusts the same requirements and restrictions which were made applicable to private foundations (i.e., those provisions relating to self-dealing, retention of excess business holdings, and the making of speculative investments or taxable expenditures, but not the current income payout requirement except where all of the interests in the trust are charitable). In addition, the House bill provided that a charitable contribution deduction (for income, gift, and estate tax purposes) for a contribution to charity in trust would not be allowed unless the trust instrument prevented the trust from violating these requirements or restrictions.

The committee is in agreement with the House that it is appropriate to prevent the possibility of taxpayers using nonexempt charitable trusts to avoid the restrictions and requirements imposed on private foundations. In the case of nonexempt charitable trusts which are split-interest trusts (i.e., trusts which have a noncharitable income beneficiary and a charitable remainder beneficiary or vice versa), however, the committee does not believe it appropriate to apply the speculative investment or excess business holdings requirement, if the interest of charity in the trust is either a relatively small income interest or a remainder interest which will not come into possession until some time in the future.

In these cases, the interest of charity in the trust property is not substantial enough in relation to the interests of the noncharitable beneficiaries to warrant the imposition of restrictions on the trust's investments. In other words, since it is unlikely that the use of a nonexempt trust in these situations would give rise to the problems of conflict of interest and diversion of attention from the interests of charity to which these restrictions and requirements are directed, it does not appear appropriate to apply them in these cases. Accordingly, the committee has modified these provisions of the House bill to make the excess business holdings and speculative investment restrictions inapplicable in these cases.

Explanation of provision.—Both versions of the bill provide generally that nonexempt charitable trusts are to be subject to the same requirements and restrictions as are imposed on private foundations (other than the current income payout requirement). The committee amendments further provide, however, that the stock ownership and speculative investment requirements imposed on private foundations are not to apply to split-interest trusts (A) in cases where charity is only an income beneficiary and the beneficial interest of charity in the trust is less than 60 percent of the value of the trust property and also (B) in cases where the only interest of charity in the trust is as a remainderman. In the latter case, the stock ownership and speculative investment requirements are to become applicable at the time the remainder interest of charity comes into possession.

The bill also provides that a charitable contribution deduction (for income, gift, and estate tax purposes) is not to be allowed for a charitable interest in a nonexempt trust unless the trust instrument expressly prohibits the trust from violating the restrictions and requirements to which it is subject (such as, self-dealing, business holdings, etc.).

Effective date.—The amendments made by these provisions of the committee amendments are to apply with respect to transfers in trust after October 9, 1969, and to contributions after December 31, 1969. In the case of a trust created before January 1, 1970, however, the amendments with respect to contributions are to apply only with respect to transfers to the trust after December 31, 1971.

10. Revenue effect

The net revenue increase under the charitable contributions deduction provisions of the bill is estimated at $5 million in 1970 and $20 million in 1972 and thereafter.

D. FARM LOSSES

1. Limitation on Deductions Attributable to Farming (sec. 211 of the bill and sec. 278 of the code).

Present law.—Under present law, income or losses from farming may be computed under more liberal accounting rules than those generally applicable in the case of other types of business activities. In general, where a significant factor in a business is the production or sale of merchandise, the taxpayer must use an accrual method of accounting and inventories. The effect of these accounting rules is to postpone the deduction of the costs of the merchandise until the accounting period in which the income from its sale is realized. These rules need not be followed, however, with respect to income or deductions from farming. In other words, a cash accounting method may be used for this purpose under which costs are deducted as incurred. A taxpayer in the business of farming is also allowed to deduct expenditures for developing a business asset which other taxpayers would have to capitalize.

For instance, the expenses of raising a breeding herd of livestock may be currently deducted. The same thing is true of expenditures to develop a fruit orchard. There also are certain other capital expenditures in connection with farming operations which a taxpayer may elect to currently deduct from ordinary income. The capital expenditures which qualify for this treatment are soil and water conservation expenditures (sec. 175), fertilizer costs (sec. 180), and land clearing expenditures (sec. 182). Under normal business accounting rules, these expenditures would be added to the basis of the farm property and, thus, would reduce the amount of capital gain realized when the property is sold. However, by allowing these expenses to be currently deducted, they reduce ordinary income rather than capital gain income.

Present law also provides that livestock held for draft, breeding, or dairy purposes for 12 months or more is eligible for capital gains treatment on its sale. Other livestock held for use in a trade or business (such as horses held for the purpose of racing) under rules generally applicable also may be eligible for capital gains treatment upon sale. The same is true of orchards held for the production of fruit crops.

General reasons for change.—The special farm accounting rules were adopted as a means of relieving the ordinary farmer of the bookkeeping chores associated with inventories and an accrual method of accounting. These rules, however, by combining the current deduction of expenses which are capital in nature with capital gains treatment on the sale of livestock or orchards have resulted in a tax abuse which the committee agrees with the House should not be allowed to continue. These rules have allowed some high-income taxpayers who carry on limited farming activities as a sideline to obtain a substantial tax loss (which does not represent an economic loss) which is then deducted from their high-bracket, nonfarm income. These tax losses often arise because of the deduction of capital costs which usually would reduce capital gains on the sale of farm property, but which instead are used to offset ordinary income when incurred.

The significance of this treatment can be illustrated by the example of a taxpayer who sells for $1,000 a product which cost him $800 of expenditures to produce. In this case, if the taxpayer can deduct these expenditures against other income, and if he is in the 50-percent bracket, his tax saving is $400, or if he is in the 70-percent bracket, it is $560. On the other hand, if his product when sold is eligible for the maximum capital gains tax treatment, his tax is $250. This means a net reduction in tax for this taxpayer of from $150 to $310 (depending on his tax bracket) despite the fact that actually a $200 gain was realized. In contrast, were the entire $800 to be treated as the cost basis for the $1,000 asset, even though the $200 gain still were taxed at capital gains rates, instead of receiving a tax reduction of from $150 to $310 the taxpayer would have an additional tax cost of $50. In other words, in these two cases there is a spread in tax consequences of from $200 to $360, depending on the taxpayer's tax bracket.

Thus, the combination of a current deduction against ordinary income for various farm expenditures which are capital in nature and the capital gains treatment granted on the sale of the asset to which the expenditures relate produce a significant tax advantage and tax saving for the taxpayer whose ordinary income is taxed in a high bracket.

The utilization of these tax advantages by high-income taxpayers is not merely a theoretical possibility. In recent years, a growing body of investment advisers have advertised that they would arrange a farm investment for wealthy persons. Emphasis is placed on the fact that aftertax dollars may be saved by the use of "tax losses" from farming operations. In addition, numerous partnerships and syndicates have been established for the purpose of allowing wealthy investors to make farm investments so as to obtain these tax advantages.

As a means of dealing with this problem, the House bill provided for the recapture of excess farm losses. Under this approach, if the taxpayer had more than $50,000 of nonfarm income, his farm losses in excess of $25,000 would be added to an excess deductions account. (These dollar limitations would only have applied to individual taxpayers.) Gains arising on the sale of farm property would be treated as ordinary income, rather than capital gains, to the extent of the amount in the taxpayer's excess deductions account. This approach to the problem of farm losses is relatively complex and one which would impose significant burdens on persons in the farming business as well as on the Government.

The basic problem which arises in connection with farm losses is that the deductions with respect to property, which gives rise to capital gain income when sold at a subsequent date, are currently deducted from ordinary income. In most cases, the effect of this is to give the deductions twice the value for tax purposes of the income to which they relate. Although the recapture approach of the House bill is one way to deal with this problem, the committee believes that a less complex and more direct approach is desirable. Accordingly, the committee has replaced the House provision providing for the recapture of excess farm losses with a limitation on the deduction of farm losses which has the effect of converting the tax value of farm losses back to the same proportion as the income to which they relate. In general, under the committee's amendments an individual with more than $50,000 of nonfarm income is to be allowed to deduct a farm loss in full to the extent it does not exceed $25,000, but is to be allowed to deduct only one-half of the loss in excess of $25,000. (A taxpayer whose nonfarm income is less than $50,000 may continue to deduct his losses in full.) These dollar limitations are to apply only to individual taxpayers and not to corporate taxpayers. The amount of the farm loss which cannot currently be deducted may be carried forward indefinitely and deducted in future years from net farm income in those years.

Explanation of provision.—The committee amendments provide that an individual taxpayer who is engaged in the business of farming and who has more than $50,000 of nonfarm adjusted gross income may currently deduct his farm losses in full to the extent they do not exceed $25,000, but may currently deduct one-half of the amount of the farm loss which is in excess of $25,000. These dollar amounts are cut in half (to $25,000 and $12,500, respectively) for married persons who file separate returns, if each of the spouses has income or deductions attributable to the business of farming for the taxable year.

In the case of taxpayers other than individuals or estates (corporations, including subchapter S corporations, and trusts) the dollar limitations are not applicable. Accordingly these taxpayers may currently deduct only one-half of their farm loss against nonfarm income.

In recognition of the fact that there are certain expenses incurred in the business of farming which involve an economic expense, the committee amendments provide that a taxpayer is to be allowed to deduct his farm loss in full to the extent of his "special deductions," if this allows a greater amount of the farm loss to be deducted currently than would be allowed under the basic limitation. The "special deductions" to which this rule applies are those deductions attributable to the business of farming which are allowed for taxes, interest, casualty or theft losses, losses and expenses directly attributable to drought, and losses from sales, exchanges and involuntary conversions.
or theft losses, losses and expenses directly attributable to losses from sales, exchanges and involuntary conversions.

As would have been true with respect to the applicability of the excess deductions account provided by the House bill, the limitation on the current deductibility of farm losses provided by the committee amendments is not to apply to taxpayers who elect to compute their farm income by using inventories and by capitalizing those farming expenditures which at present may either be deducted or capitalized. In the case of a taxpayer who makes this election and uses an accrual method of accounting in which inventories are valued on the unit livestock method, it is contemplated that the unit livestock valuation is to be changed from time to time and from area to area to reflect the actual costs of raising livestock.

Under the committee amendments the amount of a taxpayer's farm loss which is not currently deductible by reason of the limitation provided by the bill may be carried over indefinitely and deducted from his net farm income in subsequent taxable years. The amount of the carryover which may be used in a subsequent taxable year is limited to one-half of the taxpayer's net farm income for that year.

Any amount of a carryover which may not be used in a subsequent year because of this rule may continue to be carried over to following years.

If the assets of a corporation with farm loss carryovers that have not been fully utilized are acquired by another corporation in a transaction subject to section 381 (which provides for the carryover of various items in the case of certain corporate liquidations and reorganizations), the acquiring corporation is to take the unused carryovers into account as an item specified in section 381(c).

A taxpayer's farm loss for a year generally is the amount by which all deductions attributable to the business of farming carried on by the taxpayer exceed the gross income derived from that business for the year. For this purpose, gains or losses arising with respect to farm property are not to be treated as farm income or farm deductions if they are treated as long-term capital gains and losses (under section 1231(a) after the application of section 1245). These gains and losses would be treated as farm income or deductions if (under section 1321(a)) they are treated as ordinary income and losses (where losses exceed gains). In determining whether an individual taxpayer has $50,000 or more of nonfarm adjusted gross income (so as to be subject to the limitation on the current deductibility of farm losses) however, gains or losses on farm property are not to be taken into account in any case in determining the amount of the individual's nonfarm adjusted gross income (i.e., they are not to be treated as nonfarm income or losses).

The bill provides that the farming business of a taxpayer engaged in the raising of horses also is to include the racing of horses. In addition, it is provided that the farming businesses of a taxpayer who is engaged in more than one farming operation are to be aggregated and treated as one business. The bill further provides that a taxpayer who is engaged in a farming business and who also is engaged in one or more other businesses which are directly related to his farming business and are conducted on an integrated basis with that business may elect to treat all the businesses as one farming business.

As indicated above a taxpayer who elects to follow proper accounting rules is not to be subject to the limitations provided by the bill. In such a case, the taxpayer is to be treated (if the election requires him to change his method of accounting with respect to the farming business) as having made the change with the consent of the Secretary of the Treasury or his delegate. In addition, such a change is to be treated as not having been initiated by the taxpayer for purposes of the rule which precludes adjustments resulting from changes in the taxpayer's method of accounting with respect to any pre-1954 Code year.

Under the committee amendments members of a partnership are to be treated as proportionately carrying on a farming business carried on by the partnership. Thus, each partner is to take into account his proportionate share of the partnership's farm income and farm deductions.

Effective date.—This provision is to apply to taxable years beginning after December 31, 1969.

2. Depreciation Recapture (sec. 212(a) of the bill and sec. 1245(a) of the code)

Present law.—Under present law, when a taxpayer sells personal property which he has used in a business, there is a recapture of the depreciation he claimed on the property (to the extent of the gain realized on the sale). In other words, the gain on the sale of the property is not treated as a capital gain, but rather is ordinary income to the extent of the depreciation deductions claimed by the taxpayer in prior years. These recapture rules do not apply, however, in the case of livestock.

General reasons for change.—The committee agrees with the House that there is no reason why purchased livestock should be excluded from the depreciation recapture rules and, thus, treated differently than other types of property used in a trade or business. The effect of this exclusion is to allow depreciation deductions to be claimed on purchased livestock[1] and to be used to currently offset the taxpayer's other ordinary income. The livestock then may be sold by the taxpayer, and the gain taxed at the lower long-term capital gains rates. In other words, by means of the depreciation deduction for livestock, a taxpayer is able to convert income into capital gain income.

The table presented below illustrates the tax savings resulting from the depreciation of livestock.

It is assumed that 10 cows are purchased for a total cost of $36,000 and held for 3 years during which they are depreciated under the double-declining balance method. The cows are then sold at the end of the 3 years either at the original purchase price, $36,000, which would make the operation an economic breakeven, or at the price of $26,000 which would result in a $10,000 economic loss. In the case of a taxpayer in the 50-percent rate bracket where the cows are sold at the purchase price, the taxpayer receives a net tax savings of $6,333. (The net tax savings is the tax savings resulting from the depreciation deduction minus the capital gains tax on the sale of the cows.) Although economically the taxpayer neither made or lost money on the transaction, it results in a tax savings of over $6,000. If the same taxpayer had sold the cows for a price of $26,000 and thus had suffered a $10,000 economic loss, the net tax savings would be $8,834. Thus, even though the taxpayer had an economic loss of $10,000, his actual out-of-pocket cost would only be $1,166.

If the taxpayer was in the 70-percent rate bracket, the net tax savings where the transaction was an economic breakeven would be $11,400. Thus, even though the transaction produced no economic gain or loss, the taxpayer is $11,400 ahead as a result of the tax savings. If this taxpayer instead had a $10,000 economic loss, the net tax savings would be $13,900. Thus, the taxpayer would have gained $3,900 (the $13,900 tax savings minus the $10,000 economic loss) even though he had a $10,000 economic loss.

In each case the tax savings occurs because depreciation deductions are taken currently against ordinary income which is taxed at the regular rates but the gain arising on the sale of the cows is taxed only at the 25-percent capital gains rates.

[1] Raised livestock generally would have no basis so that no depreciation would be taken; however, to the extent raised livestock has a basis and is depreciated, the rules would apply.

TABLE 12.—TAX SAVING THROUGH DEPRECIATION OF CATTLE

[Assumptions: Purchase 10 purebred cows for $3,600 each; age 2 years at time of purchase; depreciated under double declining balance over next 6 years; sell at end of 3 years for $3,600 each or $2,600 each. Maintenance contracted at $500 per cow per year and contractor accepts calf at $500 as payment]

	Depreciation (33⅓ percent)	Tax saving, 50-percent rate bracket	Tax saving, 70-percent rate bracket
1 year	$12,000	$6,000	$8,400
2 year	8,000	4,000	5,600
3 year	5,333	2,667	3,733
Total	25,333	12,667	17,733
Net tax savings with capital gains tax of $6,333 (economic breakeven)[1]		6,333	11,400
Net tax savings with capital gains tax of $3,833 ($10,000 economic loss)[2]		8,834	13,900
Net out-of-pocket gain or less (tax saving minus economic loss):			
Economic breakeven case		+6,333	+11,400
Economic loss of $10,000		−1,166	+3,900

[1] The capital gain on the transaction in the economic breakeven case is simply the depreciation of $25,333 which, when taxed at the 25-percent capital gains rate, results in a tax of $6,333.

[2] The capital gain in the $10,000 economic loss case is the depreciation of $25,333 minus the loss of $10,000 or $15,333. The capital gains tax at the 25-percent rate is $3,833.

Explanation of provision.—In order to place livestock in the same position as other types of business property and to reduce the tax profit arising with respect to the type of situation described above, the House bill and the committee amendments eliminate the exception for livestock from the depreciation recapture rules. Thus, the gain on the sale or other disposition of purchased livestock with respect to which depreciation deductions have been claimed is to be treated as ordinary income rather than a capital gain, to the extent of the depreciation deductions previously claimed, in the same manner as if any other type of tangible personal property used in a business were sold.

Effective date.—This provision is to be effective with respect to taxable years beginning after December 31, 1969. The recapture rule, however, is to be applied only to the extent of depreciation deductions for periods after December 31, 1969.

3. Holding Period for Livestock (sec. 212(b) of the bill and sec. 1231(b) of the code)

Present law.—Under present law, gain from the sale of livestock held for draft, breeding, or dairy purposes qualifies for capital gain treatment if the animal has been held by the taxpayer for 1 year or more.

General reasons for change.—Generally, under present law, gain on the sale of property "used in the trade or business" may be treated as a long-term capital gain if the property was not held for customers in the ordinary course of the taxpayer's business. In the case of livestock, especially cattle and horses, the purpose for which animals are held is ambiguous. This is because the taxpayer cannot immediately know, for example, which part of a livestock crop will be retained for breeding purposes and which part will be sold in the ordinary course of his business. To deal with this problem, present law requires that the animal must be held for at least 1 year before long-term capital gains treatment can be obtained. The committee agrees with the House that in the case of cattle and horses this holding period generally is not long enough to resolve the question of whether the taxpayer is holding the animal for one of the specified purposes or whether he is holding it for sale.

Moreover, a 1-year holding period allows taxpayers to make short-term, tax-motivated investments in cattle and horses. For example, a taxpayer can go into the livestock business to build up a breeding herd over a short period of time, currently deduct the expenses (many of which are capital expenditures) of raising the animals under the cash basis method of accounting allowable to farmers, such deductions being taken against other income which is taxed in the high brackets, and then sell the entire herd at the capital gains rates. Thus, the taxpayer is able to convert ordinary income into capital gains through a short-term investment. The committee agrees with the House that this possibility of short-term, tax-motivated investments should not be allowed to continue.

The House bill extended the required holding period for livestock generally. Under the House provision, livestock would not qualify for long-term capital gains treatment unless the animal had been held by the taxpayer for at least one year after the animal normally would have first been used for draft, breeding, or dairy purposes. The House bill also extended this rule (for distinguishing between livestock held for use in a business and livestock held for sale) to animals which are used for sporting purposes, such as horse racing.

The committee believes that any extension of the livestock holding period should be confined to cattle and horses. This is the principal area in which questions have arisen. In addition, it is not clear that a longer holding period is equally applicable to, or desirable for, other types of livestock. Although the committee agrees with the House that a longer holding period for cattle and horses is needed, it believes the holding period provided by the House bill would present administrative difficulties for both taxpayers and the Government in view of its flexible nature as to when it would begin. It would appear more appropriate to the committee to provide a holding period of definite length.

Explanation of provision.—For the above reasons, the committee amendments extend the present one-year holding period for cattle and horses, which are held for draft, breeding, dairy or sporting purposes, to two years. Thus, cattle and horses are not to qualify for long-term capital gains treatment unless the animal is held by the taxpayer for at least two years for one of the specified purposes. The present one-year holding period for other types of livestock is not changed by the committee's action, other than to include animals held for sporting purposes within the scope of this rule.

The committee also agrees with the House that the mere satisfaction of the holding period requirement in the case of livestock should not, in itself, be considered to conclusively demonstrate that the animals were held for breeding purposes (or any of the other specified purposes). Thus, even though a taxpayer holds livestock for the necessary period, he should not, merely because of that fact, be treated as having held the animal for one of the specified purposes. This determination should be made on the basis of all the facts and circumstances which indicate the purpose for which the animal was held.

Effective date.—This provision is to be effective with respect to livestock acquired after December 31, 1969.

4. Exchange of Livestock of Different Sexes (sec. 212(c) of the bill and sec. 1031 of the code)

Present law.—Present law provides that property held for productive use in a trade or business or held for investment may be exchanged tax-free for property of a like-kind.

General reasons for change.—One aspect of the farm loss problem called to the committee's attention does not involve a practice permitted by present law, but rather involves an erroneous interpretation of the like-kind exchange rule of present law. It appears this rule has been incorrectly represented by some persons who promote tax-motivated livestock purchases. There appear to have been representations that male calves can be traded for female calves tax free as a like-kind exchange. The importance of this arises from the fact that ordinarily the ratio of males to females in a calf crop is approximately 50–50. Since few males are normally retained in a typical cattle operation, the remaining male calves are castrated and sold as steers at ordinary income rates. If a tax-free trade of male calves for female calves were allowed, a breeding herd of females could be built up more quickly without tax consequences.

The committee understands that the Revenue Service does not consider this to be a like-kind exchange (although it has no published position). The House Ways and Means Committee in its report on this bill noted this problem and indicated it believed that Congress did not intend this type of exchange to be considered as a like-kind exchange. It also stated its belief that allowing this treatment would be an incorrect interpretation of the statute.

The committee agrees with the House that this type of exchange should not be considered a like-kind exchange. When male calves are exchanged for female calves, the exchange does not involve like-kind property since the male animals are not held for breeding purposes and, in fact, are not of a "like-kind" with females. The committee believes, however, that it would be more appropriate to specifically deal with this matter in the bill.

Explanation of provision.—For the above reasons, the committee amendments provide that, for purposes of applying the tax-free, like-kind exchange rule of present law, livestock of different sexes are not property of a like-kind.

Effective date.—Since this provision is merely declaratory of what Congress intended in present law, it is to apply with respect to taxable years to which the Internal Revenue Code of 1954 applies.

5. Hobby Losses (sec. 213 of the bill and secs. 183 and 270 of the code)

Present law.—Present law contains a so-called "hobby loss" provision (section 270) which limits to $50,000 per year the amount of losses from a trade or business carried on by an individual that can be used to offset other income. This limitation only applies, however, where the losses from the business exceed $50,000 per year for a period of at least 5 consecutive years. In computing the amount of a loss for purposes of this provision, certain specially treated deductions are disregarded. These deductions are taxes, interest, casualty, and abandonment losses connected with a trade or business, farm drought losses, net operating loss carryovers, and expenditures which may either be capitalized or currently deducted.

General reasons for change.—The hobby loss provision generally has been of very limited application. It is often possible for a taxpayer to slightly rearrange his income and deductions so as to break the required string of 5 years. In addition, the exclusion of certain specially treated deductions from the loss computations means that a number of expenses are not considered to give rise to a loss even though they are in fact deducted. Moreover, in the few cases in which the hobby loss provision has applied so as to disallow the deduction of the loss, the taxpayer has been faced in 1 year with a combined additional tax attributable to a 5-year period.

In addition to the hobby loss provision, some court cases have provided another basis on which the loss can be denied; namely, that the activity carried on by the taxpayer from which the loss results is not a business but is merely a hobby. The committee agrees with the House that this basic principle provides a more effective and reasonable basis for distinguishing situations where taxpayers are not carrying on a business to realize a profit, but rather are merely attempting to utilize the losses from the operation to offset their other income.

The House bill replaced the present hobby loss provision with a rule which provided that a taxpayer (individual or corporate) could not deduct losses arising from an activity carried on by him if the activity was carried on without a reasonable expectation of realizing a profit from it. Where the losses from an activity were more than $25,000 in three out of five consecutive years, then the activity would have been presumed to have been carried on without the requisite expectation of profit unless it was shown to the contrary by the taxpayer.

As previously indicated, the committee is in basic agreement with the approach taken by the House to the hobby loss problem. The committee is concerned, however, that requiring a taxpayer to have a "reasonable expectation" of profit may cause losses to be disallowed in situations where an activity is being carried on as a business rather than as a hobby. Accordingly, the committee has modified the House bill to provide that in determining whether losses from an activity are to be allowed, the focus is to be on whether the activity is engaged in for profit rather than whether it is carried on with a reasonable expectation of profit. This will prevent the rule from being applicable to situations where many would consider that it is not reasonable to expect an activity to result in a profit even though the evidence available indicates that the activity actually is engaged in for profit. For example, it might be argued that there was not a "reasonable" expectation of profit in the case of a bona fide inventor or a person who invests in a wildcat oil well. A similar argument might be made in the case of a poor person engaged in what appears to be an inefficient farming operation. The committee does not believe that this provision should apply to these situations or that the House intended it to so apply, if the activity actually is engaged in for profit.

Concern also has been expressed as to whether there would be a reasonable administration of this new provision. In view of this, the committee believes that the Treasury Department should establish two advisory groups drawn from the cattle and horse industries (one concerned with the cattle industry and one with the horse industry) to assist the Commissioner of Internal Revenue in establishing standards for the application of these rules to achieve reasonable results and to resolve policy questions in their application from time to time. This action should help limit the disallowance by the Internal Revenue

Service of the deduction of losses under this provision to cases where it is generally recognized that this is appropriate. The Treasury Department has indicated its willingness to establish advisory groups of this nature.

Explanation of provision.—The committee amendments provide in general that an individual (or a subchapter S corporation) is not to be allowed to deduct losses (to the extent attributable to business deductions) arising from an activity which is not engaged in for profit. The committee amendments do not apply to corporate taxpayers (other than shareholders of subchapter S corporations), as did the House bill, since it is primarily in the case of individual taxpayers that the problem arises of a taxpayer entering into an activity to obtain a loss from the activity which is used to offset other income. In addition, the application of the provision to corporations would present a number of difficulties, such as its effect on shared facilities provided on a cost basis. No inference should be drawn from this action in the case of a corporation, however, as to whether or not any activity of the corporation is a business, or is engaged in for profit, for purposes of the tax laws.

The committee amendments provide that an activity is not engaged in for profit if deductions with respect to the activity are not allowable as trade or business expenses or as expenses incurred for the production of income or in connection with property held for the production of income. In making the determination of whether an activity is not engaged in for profit, the committee intends that an objective rather than a subjective approach is to be employed. Thus, although a reasonable expectation of profit is not to be required, the facts and circumstances (without regard to the taxpayer's subjective intent) would have to indicate that the taxpayer entered the activity, or continued the activity, with the objective of making a profit. As previously indicated, a taxpayer who engaged in an activity in which there was a small chance of a large profit, such as a person who invested in a wildcat oil well or an inventor, could qualify under this test even though the expectation of profit might be considered unreasonable.

Where an activity is not engaged in for profit, this provision specifically provides that a deduction is to be allowed for items which may be deducted without regard to whether they are incurred in a trade or business or for the production of income. This would include the deductions allowed for interest and state and local property taxes, and the long-term capital gains deduction. It is further provided that, in the case of an activity not engaged in for profit, a deduction is nevertheless to be allowed for the trade or business or production of income items which could be deducted if the activity were engaged in for profit, but only to the extent these items do not exceed the amount of gross income derived from the activity reduced by the deductions which are allowed in any event such as interest and certain state and local taxes. The deductions of this type which are to be allowed first (but after taxes, etc.) are those such as depreciation which involve basis adjustments.

Under the committee amendments a taxpayer is to be presumed to be engaged in an activity for profit for a taxable year, unless established to the contrary by the Secretary of the Treasury or his delegate, if in two or more years of the period of five consecutive taxable years ending with the current taxable year, the activity was carried on at a profit (i.e., if the gross income from the activity exceeds the deductions attributable to the activity which would be allowed if it were engaged in for profit). For purposes of this presumption, all deductions attributable to the activity other than that allowed for net operating loss carryovers are to be taken into account.

Effective date.—This provision generally is to be effective with respect to taxable years beginning after December 31, 1969. For purposes of applying the presumption, however, this provision also is to be applicable to prior taxable years.

6. Gain From Disposition of Farm Land (sec. 214 of the bill and sec. 1251 of the code)

Present law.—Present law allows a taxpayer engaged in the farming business to elect to currently deduct expenditures for soil and water conservation purposes (sec. 175) and land clearing expenditures (sec. 182) from ordinary income. Under normal business accounting rules, these expenditures would be added to the basis of the farm land and thus would reduce the amount of capital gain realized when the land is sold. However, by allowing these expenses to be currently deducted, they reduce ordinary income rather than capital gain income.

General reasons for change.—The provisions of present law which allow the current deduction of soil and water conservation expenditures and land clearing expenditures, combined with the capital gains treatment which is allowed upon the sale of the farm land to which the expenditures relate, make it possible for high-income taxpayers to make short-term, tax-motivated investments in farm land. These high-income taxpayers purchase farm land, make expenditures of this type in order to obtain current deductions against their high-bracket, nonfarm income, and then receive capital gain income when the farm land is sold, usually within a short period of time. Thus, these high-income taxpayers are able to convert their ordinary income into capital gain income.

The House bill dealt with this problem to a limited extent by treating gain on the sale of farm land as ordinary income to the extent of amounts in the taxpayer's excess deductions account or, if less, to the extent of the deductions with respect to the land for soil and water conservation expenditures and land clearing expenditures in the year of the sale and the four prior years.

The committee agrees with the House that this problem should be dealt with. Accordingly, the committee has added a provision to the bill to provide for the recapture of these expenditures upon the sale of the farm land to which they relate. To confine the application of this rule to short-term investments in farm property so it does not affect bona fide farmers who may make this type of expenditure, this bill provides for complete recapture if the property is sold within five years, a declining amount of recapture if it is sold between the fifth and ninth years, and no recapture if it is sold after the ninth year. The recapture rules are to apply only to the extent a tax benefit was derived from the deduction.

Explanation of provision.—Under the committee amendments, there is to be a recapture of a specified portion of the deductions allowed to a taxpayer for soil and water conservation expenditures or land clearing expenditures when the farm land to which they relate is disposed of, if the disposition occurs within any of the nine taxable years following the year of deduction and if a tax benefit was derived from the deductions. In other words, the gain arising on the disposition of the farm land is to be treated as ordinary income, rather than as capital gain, to the extent of the specified portion of the prior deductions for these expenditures. This treatment is to apply, however, only with respect to deductions for these expenditures which are allowed for taxable years beginning after December 31, 1969.

The amount of the deductions previously allowed for soil and water conservation expenditures or land clearing expenditures which are subject to recapture is to be determined as follows. If the deductions were allowed for the taxable year in which the farm land is disposed of or for any of the five preceding taxable years, 100 percent of the expenditures are to be subject to recapture. The amount of the deductions subject to recapture then decreases by 20 percent a year for deductions allowed in the sixth through the ninth preceding year. Thus, the percentage of the deductions subject to recapture is to be 80 percent for the sixth preceding year, 60 percent for the seventh year, 40 percent for the eighth year, and 20 percent for the ninth year. If the deductions were allowed for the tenth preceding taxable year or any earlier year, there would be no recapture.

In a case where farm land is disposed of and deductions were allowed for soil and water conservation or land clearing expenditures in different prior taxable years, the amount of each prior year's expenditures to be recaptured would be computed separately. These amounts then would be aggregated to determine the total amount of the recapture, i.e., the amount of the gain on the sale of the land which is to be treated as ordinary income.

In no event, however, would an amount greater than the amount of gain arising on the disposition of farm land be treated as ordinary income under this recapture provision. For this purpose, the amount of gain arising on a sale or exchange (or involuntary conversion) of farm land is the excess of the amount realized on the sale or exchange over the adjusted basis for the land. In the case of other types of dispositions, the amount of gain is to be determined with reference to the fair market value of the land.

Any gain which is treated as ordinary income as a result of the application of this recapture provision is generally to be recognized notwithstanding any other provision of the income tax law. The bill provides, however, that for purposes of this recapture rule, rules similar to those provided at present with respect to the recapture of depreciation on tangible personal property, relating to exceptions and limitations and to adjustments to basis, are to be applied.

Effective date.—This provision is to apply to taxable years beginning after December 31, 1969, but only to the extent of deductions allowed for taxable years beginning after that date.

7. Crop Insurance Proceeds (sec. 215 of the bill and sec. 451 of the code)

Present law.—Under present law a taxpayer who uses the cash basis method of accounting generally must report income in the year in which it is received. Accordingly, a farmer who uses this method of accounting and who receives insurance proceeds as a result of the destruction of, or damage to, his crops must include the insurance proceeds in income for the year of receipt.

General reasons for change.—The requirement of present law that crop insurance proceeds must be included in income for the year of receipt in the case of taxpayers using a cash method of accounting results in a hardship where it is the normal practice of the farmer to sell his crop in the year following that in which it is raised. In this case the farmer normally would include the proceeds from the sale of the prior year's crop in income for the taxable year and would include the proceeds from the sale of the current year's crop in income for the following year when the crop is sold. If, however, the current year's crop is damaged or destroyed, for instance by hail or windstorm and the farmer receives insurance proceeds to cover the loss, he must include the insurance proceeds in income for the current year. Thus, two years income must be reported in the current year as a result of an occurrence over which the farmer has no control.

Although the farmer presumably would have a net operating loss carryback from the following year (since there would not be income in that year to offset the expenses of raising a new crop), the committee does not believe this is an adequate solution to the problem. This requires the taxpayer to give up the additional tax for a year since he must pay the tax for the current year and then file a claim for refund after the following year in which the loss arises. In addition, it may result in the taxpayer losing the benefit of his personal exemptions and his standard or itemized deductions for the following year.

Explanation of provision.—In order to ameliorate the hardship described above, the committee has added a provision to the House bill which provides that a taxpayer who uses the cash receipts and disbursements method of accounting may elect to include crop insurance proceeds in income for the year following the year of damage or destruction, if he normally would have reported the income from the crop in that following year. For this election to be available, the taxpayer must establish that under his practice he would have reported the income from the crops in a taxable year following that in which the damage or destruction occurs.

Generally, farmers will be able to meet the requirement of establishing their practice by reference to their records which show the delivery of their crops in the year following the year in which they are harvested.

Effective date.—This provision is to apply with respect to taxable years ending after the date of enactment of the bill.

8. Revenue Effect

The revenue increase under the farm loss provisions of the bill is estimated at $25 million a year.

E. MOVING EXPENSES

(Sec. 221 of the bill and secs. 217 and 82 of the code)

Present law.—Present law allows, under specified conditions, a deduction from gross income for the following job-related moving expenses: (1) the cost of transporting the taxpayer and members of his household from the old to the new residence; (2) the cost of transporting their belongings; and (3) the cost of meals and lodging en route. The deduction is available to new employees and to nonreimbursed transferred employees but not to self-employed individuals.

For a deduction for moving expenses to be allowed, the taxpayer's new principal place of work must be located at least 20 miles farther from his former residence than was his former principal place of work (if the taxpayer had no former place of work, then at least 20 miles from his former residence). In addition, to obtain the deduction the taxpayer must be employed full-time during at least 39 weeks of the 52 weeks immediately following his arrival at the new place of work.

Present law does not specifically deal with other reimbursed moving expenses.[1] Generally, however, the courts have held that reimbursements for moving expenses, other than those which presently are deductible, are includible in gross income.

General reasons for change.—Employers frequently find it necessary to transfer employees from one location to another. Similarly, self-employed individuals relocate to find more attractive or useful employment. The mobility of labor is an important and necessary part of a dynamic, full employment economy, since it reduces unemployment and increases productive capacity. Current estimates are that there are approximately one-half million employees, including Government, military, and civilian, who are requested by their employers to move to new job locations each year. Substantial moving expenses often are incurred by taxpayers in connection with employment related moves and these expenses are widely viewed as a cost of earning income.

In view of the foregoing factors, the committee agrees with the House that more adequate recognition should be given in the tax law to the expenses which are often incurred in connection with job-related moves. In addition, however, the committee concluded that equity required that the moving expense deduction be made available on a comparable basis for self-employed who move to a new work location.

The committee also agrees with the House that the present difference in treatment between existing employees whose moving expenses are reimbursed, on the one hand, and new employees and unreimbursed transferred employees, on the other hand, is inappropriate. The present treatment allows reimbursed existing employees to exclude their reimbursement from income even though they may not satisfy the qualification tests prescribed by the law which must be met by other employees.

Under the House bill, the 39-week test is waived if the taxpayer is prevented from satisfying the test by circumstances beyond his control, such as his death or an unexpected action of his employer. The committee agrees with the action of the House with respect to this test. However, the House bill increases the distance test from 20 miles to 50 miles. The committee believes that the provision in existing law which allows the deduction for those moving to new jobs which are at least 20 miles farther from their old residence than their old job location should be restored. Limiting the deduction to those cases where the new job location is at least 50 miles farther from the taxpayer's former residence than his old job locatioh would make the provision inapplicable to many actual job-related moves. The requirement that the distance be 20 miles farther than the taxpayer's already existing commuting distance is adequate to prevent abuse.

Explanation of provision.—For the reasons discussed above, both the committee amendments and the House provision broaden the

[1] Present law does, however, provide that no deduction is to be allowed for moving expenses for any item to the extent that the taxpayer receives reimbursement or other expense allowance for such item unless the amount of the reimbursement or other expense allowance is included in the taxpayer's gross income. Thus, if an employee has claimed a deduction for moving expenses and subsequently receives a reimbursement for these expenses which he does not include in his gross income, then he must file an amended return for the taxable year in which the deduction was claimed.

categories of deductible moving expenses, provide that reimbursed taxpayers are to be treated in the same manner as unreimbursed taxpayers, and refine somewhat the application of 39-week test which must be satisfied for the deduction to be available. The committee amendments also extend the moving expense deduction to the self-employed and restore the 20-mile moving distance test.

Both versions of the bill provide that a moving expense deduction is to be allowed for three additional categories of expenses: (1) pre-move house-hunting trips; (2) temporary living expenses at the new job location; and (3) expenses of selling, purchasing or leasing a residence. These additional moving expense deductions are subject to an overall limit of $2,500, with a limit on the first two categories of $1,000.

The pre-move house-hunting trips include the costs of transportation, meals, and lodging for the taxpayer and members of his household paid for the principal purpose of searching for a new residence. The deduction is not to be available, however, unless the taxpayer (a) has obtained employment at a new principal place of work before the trip begins and (b) travels from his former residence to the general area of his new principal place of work and returns.

The temporary living expenses at the new job location include costs of meals and lodging for the taxpayer and members of his household at the new job location while waiting to move into permanent quarters. Only those expenses incurred within any 30 consecutive days after obtaining employment are to be deductible.

Residence sale and purchase expenses which qualify for the deduction are those reasonable expenses incident to the sale or exchange by the taxpayer (or his spouse) of his former residence and also expenses incident to his purchase of the new residence. Reasonable expenses incurred in settling an unexpired lease on an old residence or acquiring a lease on a new residence (except any amounts representing security deposits or payments or prepayments of rent) also may be deducted. The expenses related to the sale of the former residence include a real estate agent's commission, escrow fees, and similar expenses reasonably necessary to effect the sale or exchange of the residence. Expenses for fixing up a residence to assist in its sale are not included in this category. The expenses related to purchasing the new residence include attorney's fees, escrow fees, appraisal fees, title costs, loan placement charges (which do not represent interest) and similar expenses reasonably necessary to effect the purchase of the new residence. These expenses do not include any portion of real estate taxes, any payments which represent interest, or any portion of the purchase price of the residence. A residence for this purpose includes a house, an apartment, a cooperative or condominium dwelling unit, or other similar dwelling.

The selling expenses on the former residence which are deductible under this provision do not reduce the amount realized on the sale of the residence (for purposes of determining gain). Similarly, the expenses of purchasing a residence which have been deducted may not be added to the cost basis of the new residence (for purposes of determining gain). These adjustments are necessary to prevent double tax benefits.

The deduction for the three new additional categories of moving expenses is subject to an overall limit of $2,500, and the additional expenses related to house-hunting trips and temporary living expenses at the new job location is limited to $1,000 out of the $2,500.

If a husband and wife both commence work at a new principal place of employment within the same general location, the same $2,500 limit rule is to be applied as if there were only one commencement of work. Where a married couple files separate returns, the overall limit for these additional moving expenses is $1,250 for each, and the house-hunting trip and temporary living expenses are limited to $500 out of the $1,250. In those cases where the moving expenses (both those deductible under present law and those for which a deduction is provided by the bill) relate to an individual other than the taxpayer, a deduction is to be allowed only if the individual lives in both the former and the new residence and is a member of the taxpayer's household.

The committee amendments also provide that reimbursements of expenses of moving from one residence to another are to be included in the taxpayer's gross income (as compensation for services). Under this provision, taxpayers include the reimbursements in gross income but then are permitted to take deductions to the extent permitted under the provisions for the deduction of moving expenses.

Since compensation for services is generally subject to the withholding of income tax, moving expense reimbursements are to be subject to the general withholding rules. However, the withholding provisions (sec. 3401(a)) are not to apply to reimbursements to the extent it is reasonable to believe that a moving expense deduction will be allowable (under sec. 217).

As indicated above, the committee amendments restore the 20-mile test, modify the 39-week test, and make the moving expense deductions available for self-employed individuals. As under present law, no deduction is allowed under the 20-mile rule unless the taxpayer's new principal place of work is at least 20 miles farther from his former residence than was his former principal place of work. If the taxpayer has no former principal place of work, the deduction is allowed only if the distance between the new principal place of work and his former residence is at least 20 miles. The House bill contained a 50-mile test, for which the committee substituted the 20-mile test of present law. The committee amendments also modify this rule by providing that the distance between the two points is to be the shortest of the more commonly traveled routes between these two points.

Both the House bill and present law provide that deductions are to be allowed only if the taxpayer during the 12-month period immediately following his arrival at his new principal place of work is a full-time employee for at least 39 weeks. The committee makes no change in these rules except in the case of self-employed individuals.

Self-employed persons (who today do not qualify for any moving expense deduction) are to be allowed the deductions if during the 24-month period immediately following their arrival at the new principal place of work they perform services on a full-time basis during at least 78 weeks, of which not less than 39 weeks occurs during the 12-month period immediately following the arrival at his new place of work.[2] Whether a self-employed taxpayer performs services on a full-time basis depends upon the customary practices of his occupation. The provisions of the bill would not include the semi-retired, part-time students or other similiarly situated self-employe d taxpayers who work only a few hours each week.

[2] The self-employed rule also applies to a person who has served both as an employee and in a self-employed capacity but who is unable to meet the 39-week employee test.

If a taxpayer has not satisfied his 39-week or 78-week test before the time for filing his income tax return for the year during which the moving expenses would be deductible, as under present law, he may nevertheless claim a deduction for these expenses incurred during the earlier taxable year (if it is possible for the taxpayer at the time of filing his return still to satisfy the 39-week test). If this condition is not satisfied at the close of the subsequent year, an amount equal to the expenses which were deducted in the earlier taxable year must be included in the taxpayer's gross income for the next year.

Both the House bill and the committee amendments provide that the 39-week test is to be waived if the taxpayer is unable to satisfy it as a result of death, disability, or involuntary separation (other than for willful misconduct) from the service of, or transfer for the benefit of, an employer after obtaining full-time employment in which the taxpayer could reasonably have been expected to satisfy the requirement. Under the committee amendments, the new 78-week test is also waived in the case of death or disability.

The committee amendments define the term "self-employed individual" as an individual who performs personal services as the owner of an entire interest in an unincorporated trade or business, or as a partner in a partnership carrying on a trade or business. Under the bill, an individual who commences work at a new principal place of work as a self-employed individual is to be treated as having obtained employment when he has made substantial arrangements to commence such work.

Effective date.—This provision generally is to apply with respect to taxable years beginning after December 31, 1969. However, no deduction is to be allowed for an item to the extent the taxpayer received a reimbursement or other expense allowance for such item in a year beginning on or before December 31, 1969, which was not included in his gross income.

Revenue effect.—It is estimated that this provision will result in a revenue loss of $110 million a year.

F. MINIMUM TAXES AND ALLOCATION OF DEDUCTIONS

(Sec. 301 of the bill and secs. 56, 57, and 58 of the code)

Present law.—Under present law, many individuals and corporations do not pay tax on a substantial part of their economic income as a result of the receipt of various kinds of tax-exempt income or special deductions. In addition, an individual is permitted to charge his personal or itemized tax deductions entirely against his taxable income without charging any part of these deductions to his tax-free income.

Both individuals and corporations, for example, now pay the equivalent of the regular income tax on only part of their long-term capital gains. Individuals with large interest payments on funds borrowed to carry growth stock may use the interest deduction to reduce other unrelated taxable income. They may offset practically all their income in this manner and, as a result, pay little or no tax. Similarly, individuals and corporations may escape tax on a large part of their economic income if they receive accelerated depreciation on real property and intangible drilling and development expenses and percentage depletion in excess of cost depletion. Financial institutions also pay lower taxes than other corporations to the extent that their deductions for bad debt reserves exceed the deductions that would be allowed on the basis of actual loss experience.

General reasons for change.—The present treatment which permits individuals and corporations to escape tax on certain portions of their economic income results in an unfair distribution of the tax burden. This treatment results in large variations in the tax burdens placed on taxpayers who receive different kinds of income. In general, high-income individuals, who get the bulk of their income from personal services, are taxed at high rates. On the other hand, those who get the bulk of their income from such sources as capital gains or who can benefit from accelerated depreciation on real estate pay relatively low rates of tax. In fact, individuals with high incomes who can benefit from these provisions may pay lower average rates of tax than many individuals with modest incomes.

For example, in 1964, the 1,100 returns with adjusted gross incomes over $200,000 paid an average tax of 22 percent of economic income. These 1,100 returns paid tax on about 32 percent of income after various exclusions and personal deductions. In recent years there have been a significant number of cases where taxpayers with economic incomes of $1 million or more paid little or no tax.

Similarly, corporations with long-term capital gains, accelerated depreciation, intangible drilling and development expenses and percentage depletion, and financial institutions with special deductions for additions to bad debt reserves tend to pay smaller amounts of tax than other corporations.

The committee has adopted many provisions that are specifically designed to reduce the scope of existing tax preferences. However, the committee believes that an overall minimum tax on tax preferences is also needed to reduce the advantages derived from these preferences and to make sure that those receiving such preferences also pay a share of the tax burden. As indicated below, the committee has amended the House bill to substitute an overall minimum tax for the limit on tax preferences and the allocation of deductions provisions in the House bill. Under the committee provision, individuals and corporations are to total their tax preference items, subtract an exemption of $30,000, and apply a 5 percent rate to the remainder. This will be their minimum tax.

The committee believes that this minimum tax will be a more effective and considerably simpler method of imposing tax on preference items than the House provisions. The House provisions would place a limit on certain tax preference items of individuals (amounting to one-half the sum of these tax preferences and income subject to tax) and would also require personal deductions to be allocated between taxable income and tax preference income. The House bill incorporates both these provisions because neither provision alone would impose significant taxes on those with substantial amounts of nontaxable income. For example, if the limit on tax preferences were used alone, then an individual could have tax preference income amounting to as much as one-half his total economic income and yet not pay any tax on such preferences. Accordingly, an additional provision, such as allocation of deductions, was required.

However, the House approach for the combined use of the limit on tax preferences and the allocation of deductions has important drawbacks. While these provisions together would impose significant taxes on those with substantial amounts of tax preference income, they produce different tax burdens on preference income for two individuals with the same amounts of tax preference income but with different amounts of taxable income. Moreover, these provisions would greatly complicate the preparation of tax returns for those to whom they apply. Much of this complexity arises from the inclusion of regular taxable income and tax preferences in the same tax base. This presents difficulties wherever there is a limitation on a particular deduction based on income under the regular tax computation since the limit on tax preferences affects the amount of taxable income and the amount of taxable income in turn affects the particular deduction and the limit on tax preferences.

Moreover, the House provisions for a limit on tax preferences and allocation of deductions would apply only to individuals and not to corporations. In large measure, this is because these provisions do not lend themselves to the taxation of preferences enjoyed by corporations. For example, a corporation with sufficient tax preferences to be affected by these provisions could arrange to escape from their impact by merging with other corporations with relatively small amounts of tax preference income.

The minimum tax provided by the committee avoids these problems since it merely involves applying the 5 percent rate to tax preference income in excess of the specified exemption. It also differs from the House provisions in that it does not treat differently two individuals with the same amounts of tax preference income merely because they have different amounts of taxable income. In addition, the minimum tax is readily applicable to corporation tax preferences since, unlike the House provisions, it is not feasible for corporations to avoid this tax through mergers.

Explanation of provision.—Under the committee provision, individuals and corporations are to total their tax preference income, subtract an exemption of $30,000, and apply a 5 percent rate to find the minimum tax. This minimum tax is in addition to the regular income tax or the regular corporation income tax.

Spouses who file separate returns and each have tax preferences will each receive a $15,000 exemption for purposes of the minimum tax. In the case of members of a controlled group of corporations, the $30,000 exemption under the minimum tax is to be divided equally among the members of the group unless they agree to share the exemption in another way.

The items of tax preference included in the base of the 5 percent tax under the committee amendment are as follows:

(1) Excess investment interest.[1]—This is the excess of investment interest expense over net investment income (i.e., investment income less investment expenses). Investment income consists of gross income from interest, dividends (other than dividends from foreign subsidiaries), rents and royalties, net short-term capital gain from property held for investment purposes, and amounts treated as ordinary income under the recapture

[1] Items identified by this footnote represent tax preferences not covered by the House provisions for a Limit on Tax Preferences and Allocation of Deductions which are subject to the 5-percent minimum tax under the Finance Committee provision.

rules (secs. 1245 and 1250) but only to the extent such income and gain is not derived from the conduct of a trade or business. Investment income for this purpose does not include income from property subject to a net lease entered into before October 10, 1969. Investment expenses for this purpose include State and local property taxes, bad debts, straight-line depreciation, amortizable bond premium, cost depletion, dividends received deduction allowed corporations, and other expenses to the extent these expenses are directly attributable to the production of such investment income. Investment interest expense, as distinguished from other interest expense, is that on indebtedness incurred or continued to purchase or carry property held for investment purposes. Generally, investments carried by a financial institution would be directly related to the trade or business carried on by the institution, and interest paid to purchase or carry such assets would not be considered investment interest. However, interest incurred to purchase or carry unrelated investments, such as equity securities or undeveloped land, would be classified as investment interest, and to the extent it exceeded the income from such assets, it would be a preference item.

(2) Accelerated depreciation on personal property subject to a net lease.[1]—This is the accelerated depreciation in excess of the straight-line depreciation. Net leases for this purpose involve those situations where the lessor is either guaranteed a specific return or is guaranteed in whole or in part against the loss of income. Net leases also include those situations where the trade or business expense deductions are less than 15 percent of the rental income produced by the property.

(3) Accelerated depreciation on real property.—This is the excess of the fast depreciation allowed over straight-line depreciation.

(4) Amortization of rehabilitation expenditures.[1]—This is the amortization deduction to the extent it exceeds straight-line depreciation.

(5) Amortization of certified pollution control facilities.[1]—This is the excess of the amortization deduction over accelerated depreciation.

(6) Amortization of railroad rolling stock.[1]—This is the excess of the amortization deduction over accelerated depreciation.

(7) Bargain element in stock options.[1]—In the case of qualified stock options (or restricted stock options), this is the excess of the fair market value of the stock at the time of the exercise of the option over the option price of the stock.

(8) Bad debt deductions of financial institutions.[1]—In the case of a bank, saving and loan association, mutual savings bank or other financial institution, this is the amount by which the bad debt reserve deduction exceeds the amount which would be allowable to the bank or other institution had it maintained its bad debt reserve on the basis of its own actual bad debt loss experience or, in the case of a new institution, industry experience.

(9) Depletion and intangible drilling and development costs.—This is the sum of two items: the deduction for intangible drill-

[1] Items identified by this footnote represent tax preferences not covered by the House provisions for a Limit on Tax Preferences and Allocation of Deductions which are subject to the 5-percent minimum tax under the Finance Committee provision.

ing and development costs (other than those incured in drilling a nonproductive well) and the excess of the depletion deduction taken for the year over the cost of the property reduced for depletion taken in prior years. In this case the intangible drilling and development costs, to the extent that they are treated directly as a preference item, are treated as a part of the recoverable cost in determining the depletion preference.

(10) Capital gains.—In the case of individuals, one-half of the net long-term capital gain, to the extent it exceeds the net short-term capital loss. In the case of corporations, the tax preference is the excess of the net long-term capital gain over the net short-term capital loss, multiplied by a ratio in which the denominator is the regular corporate rate (48 percent) and the numerator is the regular corporate rate minus the rate applicable to capital gains in the case of corporations (28¾ percent in 1970 and 30 percent thereafter). In other words, the corporate capital gains are included among the tax preferences in the ratio of the difference between their special tax rate and the general corporate tax rate to the general corporate tax rate. Thus, after 1970 ⅜ of a corporation's net long term capital gain will be treated as a tax preference (48%–30%÷48%).

The tax preferences listed above are generally subject to the 5-percent minimum tax only when derived from domestic sources. However, the tax benefits of stock options and capital gains preferences (items 7 and 10 above), which are derived from sources outside the United States will also be subject to the minimum tax if the foreign country either does not tax these items or taxes them at a preferential rate. Moreover, the remaining items of tax preference set forth above which are attributable to income from sources outside the United States will also be subject to the minimum tax to the extent that they result in foreign losses which reduce taxable U.S. income. The amount of tax preferences so included is not to exceed the amount of the foreign losses. For these purposes, taxable income from sources in the United States which is offset by foreign losses will be deemed to have been reduced by foreign preferences, but not to an extent greater than these losses. In addition, for these purposes, foreign tax preferences and foreign losses are to be measured on a country-by-country basis where the taxpayer takes his foreign tax credit on a per-country basis and on an overall basis when he takes his foreign tax credit on an overall basis or takes the foreign tax as a deduction. The foreign tax credit is not to be allowed against the 5-percent minimum tax. Preference items attributable to activity on the continental shelf of the United States will be considered for purposes of the minimum tax as preference items from within the United States to the extent they are related to natural resource activity.

In a number of respects the minimum tax provided by the Finance Committee has broader scope than the House provisions for a limit on tax preferences and allocation of deductions. The minimum tax provided by the committee covers a number of tax preference items that were not included in the House LTP and allocation provisions. These are designated with a footnote reference in the above list of items subject to the minimum tax. The minimum tax also applies to both corporations and individuals while the House provisions apply only to individuals. This makes the scope of the minimum tax broader even where the same item, such as accelerated depreciation on real property, is included as a tax preference item under both the House provisions and the committee's provision. In addition, the extension of the minimum tax to corporations makes it possible to subject to this tax a number of preferences that pertain primarily to corporations such as the excess bad debt deductions of financial corporations.

Three items which were treated as tax preferences under the House provisions are not subject to the 5-percent minimum tax. The latter does not apply to interest on State and local government bonds which were covered by the House provisions.[2] The committee believes, on the basis of the testimony received during its hearings on the tax reform bill, that the taxation of State and local bond interest—even if this were done indirectly by means of inclusion in a minimum tax provision—would constitute an inefficient tax reform. State and local governments are now encountering very considerable difficulties in marketing their bonds in view of present record interest rates and tight money conditions. The taxation of State and local bond interest would add to these difficulties and make it still more difficult for State and local governments to raise needed funds. The committee is hopeful that its action in excluding the interest on such bonds from the scope of the minimum tax will restore confidence to the tax-exempt bond market and enable State and local governments to get on with the important work of improving services and facilities for their own citizens.

The minimum tax in the bill also does not include any appreciation in the value of property deducted as a charitable contribution. Where such appreciation was not included in taxable income, it was included in the House provisions for a limit on tax preferences and allocation of deductions. The committee does not believe that it is wise to include gifts of appreciated property to charity under the 5-percent minimum tax in view of the fact that the committee's bill contains a number of other provisions specifically directed towards curtailing the tax advantages resulting from such gifts. The committee believes that the principal effect of including gifts of appreciated property in the minimum tax would be to reduce the benefit of the contribution and thus unduly restrict public support of worthwhile educational and other public charitable institutions.

Finally, the minimum tax does not cover farm losses resulting from special farm accounting rules, which were included in the House provisions. The committee has adopted a provision which is specifically directed to eliminating undue tax advantages in this area. Accordingly, the committee believes that to cover such farm losses in the minimum tax is not necessary and would have the disadvantage of creating apprehensions for large numbers of farmers to whom the tax would not apply.

As a general rule, the deductions provided under the regular individual and corporate income taxes will not be allowed for purposes of the minimum tax. This is because once the items have been deducted

[2] The House bill included interest on all issues of State and local securities under the limit on tax preferences, and interest on State and local bonds issued on or after July 12, 1969, under the allocation of deduction provision. In both cases, the relevant tax-exempt interest was taken into consideration gradually under a transition rule which provided that in the first year one-tenth of the interest would be taken into account, two-tenths in the second year, etc., until 100 percent of the pertinent interest would be recognized.

under the regular income tax, allowing them over again under the minimum tax would provide duplicate tax allowances. The committee's provision makes one exception to this rule with regard to net operating losses. Generally, it will be preferable to use a net operating loss carryover against regular income rather than to reduce the tax preferences subject to the 5 percent tax. The bill, however, allows the deferral of the 5 percent tax in such cases until it is clear that the net operating losses will be available for offset against regular income during the 5-year carryforward period. Should the net operating losses not be usable in this manner, the tax base for the 5 percent minimum tax would to a corresponding extent never be applied. In effect, the 5 percent tax is treated as being imposed in the year the net operating loss is used and is payable in that year (but taking account of the exemption of the prior year).

For purposes of the minimum tax, tax preferences are attributed to an estate or trust and the beneficiaries in the same ratio as the income of the estate or trust except for preference amounts representing depreciation or depletion specifically allocated in the governing instrument, which are attributed as so allocated. The exemption available to the trust or estate is reduced in similar proportions.

For subchapter S corporations (where the income is taxed to the shareholders), items of tax preference are to be apportioned among the shareholders in a manner consistent with the way the losses are apportioned among the shareholders and not treated as preferences of the corporation. However, where capital gains are taxed to both the subchapter S corporation and the shareholder (under sec. 1378), the capital gains tax preference is subject to the minimum tax at both the corporate and the individual level. In such a case, the amount treated as capital gain by the shareholder is reduced by the tax imposed under section 1378 (as under present law) and by the 5 percent minimum tax imposed at the corporate level.

Regulated investment companies are not to be subject to the minimum tax to the extent they pass through to shareholders amounts attributable to tax preferences. However, their shareholders are to be subject to minimum tax on capital gains tax preferences passed through to them. In addition, the shareholders will be deemed for purposes of the minimum tax to have received other tax preferences in proportion to the amounts of income of regulated investment company and other distributions which are made to them.

Certain items subject to the 5-percent minimum tax, such as accelerated depreciation, involve tax deferral and not permanent escape from taxation. The committee is aware that in these instances some case could be made for providing adjustments to basis to avoid double taxation. For example, the fact that accelerated depreciation in excess of straight-line depreciation is subject to a 5-percent minimum tax might be advanced as grounds for some increase in the basis of the property involved. However, the committee concluded that, as a practical matter, it would be best not to provide for such basis adjustments under a 5-percent tax since such adjustments would complicate the minimum tax. Moreover, the fact of deferring tax for an extended period of time is itself a tax preference for which the 5-percent tax is a moderate charge.

Effective date.—This provision applies with respect to taxable years ending after December 31, 1969 but in applying the minimum tax to fiscal years beginning in 1969 and ending in 1970, the tax will be imposed on a pro rata basis.

Revenue Effect.—It is estimated that the 5-percent minimum tax will increase revenue by an estimated $650 million in 1970 and $700 million in the long run. Of this amount, an estimated $380 million will be accounted for by corporations and $320 million by individuals. The minimum tax provided by the committee's provision will, therefore, furnish substantially more revenue than the estimated $555 million annual increase in revenue resulting from the House provisions subjecting individuals to the limit on tax preferences and allocation of deductions.

G. INCOME AVERAGING

(Sec. 311 of the bill and secs. 1301–1305 of the code)

Present law.—Present law provides a general averaging provision for an individual whose income fluctuates widely from year to year or increases rapidly over a short period. Generally, the present averaging provision allows the excess of the current year's taxable income over 1⅓ times the average taxable income of the prior 4 years to be taxed at lower bracket rates than would otherwise apply.

Certain types of income such as long-term capital gains, wagering income, and income from gifts are not eligible for averaging.

The determination of the income subject to averaging is based upon calculations which determine the extent to which the current year's taxable income (after certain exclusions) exceeds 133⅓ percent of taxable income (with approximately the same adjustments) in the 4 prior years. If this excess over the 133⅓ percent, which is known as "averagable income", is more than $3,000, averaging is available to the individual. The tax on this "averagable income" is determined by taking ⅕ of this income and adding it to 133⅓ percent of the average of the taxable income (with adjustments) for the 4 prior years. The tax on this additional amount is then multiplied by 5. This is the averaging device available to individuals under present law.

General reasons for change.—The committee believes that the 133⅓ percent test described above is too restrictive in that it denies the benefits of averaging to those with an increase in income that can be considered quite substantial. To limit averaging to income above 133⅓ percent significantly reduces the benefits of averaging for those who are eligible. The 133⅓ percent was included in the general income averaging adopted in 1964 in large part because it was believed it was necessary to limit for administrative reasons the availability of a new and unfamiliar averaging provision to those cases where it was needed most. Greater familiarity with income averaging from the point of view of tax administration and taxpayers, however, has reduced the significance of this consideration. In view of this, the committee has concluded that it is appropriate to reduce this percentage to 120 percent.

Explanation of provision.—The committee amendments provide that a taxpayer is to be allowed to average that part of his current year's taxable income (with exclusions) which exceeds 120 percent of his average taxable income (with exclusions) in the four prior years (if he meets the $3,000 test). Thus, for averaging to be available, his excess income in the current year needs to be only 20 percent, rather than 33⅓ percent, greater than his average income for the prior four years.

The House bill made averaging available to long-term capital gains, income from gifts, and wagering income. The committee decided that permitting averaging of these types of income would provide them with an unwarranted benefit and would be inconsistent with the general purpose of the averaging provision, as was concluded in 1964 when these items were deliberately excluded.

The committee amendments also modify the House provision which deny a taxpayer who elects income averaging the benefits of the limitation on tax imposed as a result of the application of the throwback rules in the case of a beneficiary of an accumulation trust. Since the committee amendments to the accumulation trust provisions changed the limitation on tax into a special tax on accumulation distributions, the committee amendments to the averaging provisions provide that a taxpayer who receives these trust distributions can elect income averaging even though he computes the special tax on the trust distribution. However, in such a case a trust distribution is to be excluded from the portion of the income eligible for averaging. This is consistent with the intention of the House provision to insure that a taxpayer does not receive a double benefit from the lower tax on the accumulation distribution and also averaging of the same income.

Effective date.—These provisions apply to taxable years beginning after December 31, 1969.

Revenue effect.—It is estimated that the revenue loss from these provisions will be $110 million per year.

H. RESTRICTED PROPERTY

(Sec. 321 of the bill and secs. 83, 402(b), and 403(c) of the code)

Present law.—Present law does not contain any specific rules governing the tax treatment of deferred compensation arrangements known as restricted stock plans.

A restricted stock plan, generally, is an arrangement under which an employer transfers stock to one or more of his employees (often without the payment of any consideration), where the stock is subject to certain restrictions which affect its value. A restricted stock plan may cover only one employee or it may cover a number of employees. The stock transferred under a plan may be stock in the employer corporation, stock of another company—often an unrelated growth company—or even shares of a mutual fund.

The restrictions which are imposed on the stock are of various types. One type of restriction often imposed requires the employee to return the stock to the employer if he does not complete a specified additional period of employment and prohibits the employee from selling the stock in the interim. Another common type of restriction provides that the employee may not sell the stock for a specified period of time, such as a 5-year period, or until he retires.

The existing Treasury regulations generally provide that no tax is imposed when the employee receives the restricted stock. Tax is deferred until the time the restrictions lapse; at that time, only the value of the stock when it was transferred to the employee (determined without regard to restrictions) is treated as compensation, provided the stock has increased in value. If the stock has decreased in value in the interim, then the lower value at the time the restrictions lapse is considered the amount of compensation. Thus, under existing regulations there is a deferral of tax with respect to this type of compensation, and any increase in the value of the stock between the time it is granted and the time when the restrictions lapse is not treated as compensation.

The existing Treasury Regulations also provide that the employer is entitled to deduct compensation at the time and in the same amount as the employee is considered to have realized income. In the case of nonexempt trusts, however (where the income to the recipient is deferred if his rights to the contribution are forfeitable), employers under the regulations are not allowed deductions for property contributed to these trusts.

General reasons for change.—The present tax treatment of restricted stock plans is significantly more generous than the treatment specifically provided in the law for other types of similarly funded deferred compensation arrangements. An example of this disparity can be seen by comparing the situation where stock is placed in a nonexempt employees' trust rather than given directly to the employee subject to restrictions. If an employer transfers stock to a trust for an employee and the trust provides that the employee will receive the stock at the end of 5 years if he is alive at that time, the employee is treated as receiving and is taxed on the value of the stock at the time of the transfer. However, if the employer, instead of contributing the stock to the trust, gives the stock directly to the employee subject to the restriction that it cannot be sold for 5 years, then the employee's tax is deferred until the end of the 5-year period. In the latter situation, the employee actually possesses the stock, can vote it, and receives the dividends, yet his tax is deferred. In the case of the trust, he may have none of these benefits, yet he is taxed at the time the stock is transferred to the trust.

It has been suggested by some that restricted stock plans are not in fact, deferred compensation arrangements, but rather are a means of allowing key employees to become shareholders in the business. This line of reasoning, however, overlooks the fact that in 1964 Congress specifically dealt with the matter of the appropriate means by which key employees could be provided with a stake in the business when it revised the treatment of qualified employee stock options.

A series of specific requirements were provided by Congress at that time which must be satisfied in order to obtain favorable tax treatment in the case of stock options. A number of these requirements were designed to decrease the compensatory nature of stock options and to place more emphasis on stock options as a means of giving employees a stake in the operation of their business. Agreeing with the House bill, the committee does not believe it was intended that substantially similar tax benefits should be available under a slightly different type of arrangement, such as a restricted stock plan, where none of the conditions which it specified for qualified stock options must be satisfied.

To the extent that a restricted stock plan can be considered a means of giving employees a stake in the business, the committee believes the present tax treatment of these plans is inconsistent with the specific rules provided by Congress in the case of qualified stock options, which were considered by Congress as the appropriate means by which an employee could be given a shareholder's interest in the business.

Explanation of provisions.—Both the House bill and the committee amendments provide that a person who receives a beneficial interest in property, such as stock, by reason of his performance of services is to be taxed on the value of the property at the time of receipt unless his interest in the property is subject to a substantial risk of forfeiture. In this latter case, he is to be taxed on the value of the property at the time the risk of forfeiture is removed.

If there is no substantial risk of forfeiture, the recipient of the beneficial interest is required to include income at the time of the receipt of the property the excess of the fair market value of the property over the amount paid for it. For this purpose, the fair market value of the property is to be determined without regard to any restriction, except a restriction which by its terms will never lapse. Agreeing with the House bill, the committee feels that restrictions which by their terms never lapse—for example, a requirement that an employee sell his stock back to the employer at book value or some other reasonable price if he terminates his employment—are not tax motivated and should be distinguished from restrictions designed to achieve deferral for tax saving purposes.

If, at the time the property is transferred to the person, his interest in the property is subject to a substantial risk of forfeiture, he is not to be required to include any amount in income with respect to the property until such time as his interest in the property either becomes transferable or no longer is subject to a substantial risk of forfeiture. A substantial risk of forfeiture will be considered to exist where the person's rights to the full enjoyment of the property are conditioned upon his future performance of substantial services. In other cases, the question of whether there is a substantial risk of forfeiture depends upon the facts and circumstances. An interest in property will be considered to be transferable only if the rights of a transferee are not subject to any substantial risk of forfeiture.

In the situation where a person is allowed to sell property only at a price determined under a formula, and this restriction by its terms will never lapse, the restriction is taken into account in valuing the property. In such a case, the restriction is an inherent limitation on the recipient's property rights, and his income should be determined accordingly. The bill provides that the formula price is to be deemed to be the fair market value of the property, unless established to the contrary by the Secretary or his delegate.

If a restriction on property which by its terms will never lapse is canceled, the owner of the property, in effect, is to include in income as compensation, for the taxable year in which the cancellation occurs, the net increase in value he realizes as a result of the cancellation. The bill provides that the amount included in income is to be the excess of the fair market value of the property (computed without regard to the restriction) at the time of cancellation over the sum of: (1) the fair market value of such property (computed by taking the restriction into account) immediately before the cancellation, and (2) the amount, if any, paid for the cancellation. This rule is not to apply, however, if the owner of the property can establish that the cancellation is not compensatory and that the person who would be entitled to a deduction if it were compensatory will not treat the transaction as compensatory.

The rules provided by the bill with respect to restricted property are not to apply to: (1) a transaction which involves a stock option (to which sec. 421 applies); (2) a transfer to or from a qualified trust (described in section 401(a)) or to a transfer under an annuity plan meeting the requirements of section 404(a)(2); (3) the transfer of an option without a readily ascertainable fair market value; or (4) the transfer of property pursuant to the exercise of an option with a readily ascertainable fair market value at date of grant. The exception for qualified annuity plans was not in the House bill.

The holding period for property subject to the restricted property rules prescribed by the bill is to begin at the first time the taxpayer's rights in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier (i.e., the time he is deemed to receive compensation).

The committee, in accord with the House bill, modified the tax treatment of nonexempt trusts and nonqualified annuities to conform with the treatment of restricted property. Thus, if an employer contributes cash to a nonqualified trust or a nonqualified annuity plan and the employee's rights are forfeitable when the contribution is made but subsequently become nonforeitable, the employee is to be taxable on the contribution at the first time his rights are not subject to a substantial risk of forfeiture instead of the later time when the contribution is distributed to him under the annuity contract (as provided by present law except in the case of annuities purchased by exempt organizations).

The committee adopted provisions to make it clear that in the case of nonexempt trusts and nonqualified annuities, the amount subject to tax when the employee's interest becomes nonforfeitable is the value at that time of his interest in the trust (or the then value of the annuity contract). The value of the amounts subsequently contributed by the employer to the trust (or premiums subsequently paid) are to be included in the income of the employee when contributed or paid to the trust (or insurer), if the employee's interest in such amounts is nonforfeitable.

Although the committee adopted the major provisions of the House bill relating to restricted stock, it made several minor modifications.

The House bill requires the recognition of income by an employee upon receipt even though his interest in the property is forfeitable if it is transferable. The committee believes that the employee should not be treated as realizing income merely because he can give his forfeitable interest to another person, if the other person is also subject to the forfeitability condition. The committee change provides that an interest in property is to be considered to be transferable only if a transferee would not be subject to the forfeitability conditions—for example, where the employee has a forfeitable interest in stock, but the fact of forfeitability is not indicated on the stock certificate, and a transferee would have no notice of it.

Under another modification made by the committee, where the employee gives forfeitable property to another person, he (and not the donee) would be taxable at the time the donee's rights become nonforfeitable. However, if an employee who has a forfeitable interest in property sells the property in an arm's length transaction, the employee will be treated as realizing income at that time.

To add flexibility, the committee adopted a provision allowing recipients of restricted property the option of treating it as compensation in the year it is received, even though it is nontransferable and subject to a substantial risk of forfeiture. If this election is made, the restricted property rules are not to apply, and later appreciation in the value of the property is not to be treated as compensation. However, if the property is later forfeited, no deduction is to be allowed with respect to the forfeiture. The employee must make this election not later than 30 days after the date of transfer (or the date of enactment of the bill, if later). The election may not be revoked except with the consent of the Secretary of the Treasury or his delegate.

Another provision adopted by the committee provides that the restricted property rules will not apply to premiums paid by an employer under nontrusteed employee annuity plans which meet the requirements for tax exemption (of section 401(a)). Also, the restricted property rules will not apply to any amount excluded from gross income (under section 403(b)) in the case of annuities purchased for an employee by an educational or charitable (section 501(c)(3)) organization.

The committee amendments provide that if restricted stock (or other property) is exchanged in a tax-free exchange for other stock (or property) subject to substantially the same restrictions, the exchange will not cause the holder of the stock to become taxable, and the stock received in the exchange will be treated as restricted property. The same principal applies where stock not subject to the restricted property provision because of the effective date is exchanged in a tax-free exchange. The stock received in the exchange is not to be treated as subject to the new restricted property rules if it is subject to substantially the same restrictions as the stock given up.

The committee provided rules for the employer's deduction for restricted property given to employees as compensation. The allowable deduction is the amount which the employee is required to recognize as income. The deduction is to be allowed in the employer's accounting period which includes the close of the taxable year in which the employee recognizes the income. Where restricted property is not subject to the new rules governing recognition of income, existing rules regarding the amount of the deduction will continue to apply.

The committee provided with respect to nonexempt trusts that the employer will be allowed a deduction for his contribution at the time that the employee recognizes income, providing that separate accounts are maintained for each employee. Under present regulations, no deduction would ever be allowed by the Internal Revenue Service in those cases where the taxation of the income to the beneficiary of a nonexempt trust is deferred.

In general, where a parent company's or a shareholder's stock is used to compensate employees under a restricted stock plan, the transfer of the stock by the parent company or shareholder is to be treated as a capital contribution to the company which is to be entitled to a deduction in accordance with the restricted property rules. The parent company or the shareholder merely is to reflect the contribution as an increase of the equity in the company which is entitled to the compensation deduction.

When property other than the employer company's own stock is given as compensation to an employee subject to a substantial restriction and the restrictions lapse at a later date, the company is required under existing law to recognize income in an amount by which the compensation deduction exceeds the company's basis in the property. Likewise, where the basis of the property exceeds the amount recognized as the compensation deduction, the employer can deduct this amount as a loss. The gain or loss would be reported in the employer's accounting period which includes the close of the taxable year in which the employee recognizes the compensation income. The committee intends no change in these rules of existing law.

Effective date.—Generally, these rules are to apply to property transferred after June 30, 1969. The bill provides transitional rules, however, where the following situations are not to be subject to the new rules: (1) where property is transferred pursuant to a written contract entered into before April 22, 1969; (2) where the property is transferred upon the exercise of an option granted before April 22, 1969; or (3) where the property is transferred before May 1, 1970 (the House bill stated February 1, 1970), pursuant to a written plan adopted and approved before July 1, 1969.

Whether a contract is binding under (1) above is a matter to be determined under State law. The binding nature of a contract is not to be negated by a provision which allows the employee to terminate the contract for any year and receive cash instead of restricted property, if such an election would cause a substantial penalty such as forfeiture of part or all of earlier years' compensation awards. A plan is to be considered as having been adopted and approved under (3) above before July 1, 1969, if prior to that date the employer undertook an ascertainable course of conduct which under applicable law does not require further approval by the board of directors or the stockholders. Thus, stockholders' approval is not required under this provision unless State law requires the approval of stockholders to be obtained.

The committee added a transitional rule which provides that property transferred before January 1, 1973, is to be excluded from the new rule if before April 22, 1969, the company had a binding contract with a third party (such as a tax-exempt foundation) to pay key employees a determinable amount of stock each year until a fixed number of shares have been transferred.

Revenue effect.—The revenue impact of this provision is believed to be negligible in terms of any pickup in revenue from existing law. This is because restricted stock plans, for the most part have the effect of merely shifting the tax liability.

I. ACCUMULATION TRUSTS, MULTIPLE TRUSTS, ETC.

(Secs. 331, and 332 of the bill and secs. 663, 665, 666, 667, 668, 669, 670, 677, and 6401 of the code)

Present law.—The general approach of present law with respect to the taxation of trusts is to treat the trust as a separate entity which is taxed in the same manner as an individual. However, there is one important difference: the trust is allowed a special deduction for any distributions of ordinary income to beneficiaries. The beneficiaries then include these distributions in their income for tax purposes. Thus, in the case of income distributed currently, the trust is treated as a conduit through which income passes to the beneficiaries, and the income so distributed retains the same character in the hands of the beneficiary as it possessed in the hands of the trust.

If a grantor creates a trust under which the trustee is either required, or is given discretion, to accumulate the income for the benefit of designated beneficiaries, however, then, to the extent the income is accumulated, it is taxed at individual rates to the trust. An important factor in the trustee's (or grantor's) decision to accumulate the income may be the fact that the beneficiaries are in higher tax brackets than the trust.

When the trust distributes accumulated income to the beneficiaries, in some cases they are taxed on the distributions under a so-called throwback rule. The throwback rule treats the income for tax purposes as if it had been received by the beneficiary in the year in which it was received by the trust. The beneficiary recomputes his tax for these back years, adding the trust income to it and taking credit for the tax which had been paid by the trust on that income, and pays the additional tax due (if any) in the current year. The beneficiary is taxed, under this rule, however, only on the part of the distribution of accumulated income which represents income earned by the trust in the 5 years immediately prior to the distribution.

In addition to the limitation of its application to the 5 years preceding the year of distribution, the throwback rule does not apply to several types of distributions:

(1) a distribution of the income which was accumulated prior to the beneficiary's attaining of the age of 21;

(2) a distribution of accumulated income to a beneficiary to meet his "emergency needs";

(3) a distribution of accumulated income which is a final distribution, and which is made more than 9 years after the last transfer to the trust;

(4) a distribution of accumulated income not in excess of $2,000; and

(5) certain periodic (not more than four distributions per beneficiary, each at least 4 years apart) mandatory distributions under trusts created prior to 1954.

If the accumulation distribution falls within one of these exceptions, the throwback rule does not apply, and the trust rather than the beneficiary is taxed on this income.

Where the trust has capital gains in a year, the trustee may allocate (or in most cases be required to allocate) the capital gains to corpus. In this case, these gains are taxed to the trust in the year earned and there are no further tax consequences upon the distribution of these capital gains in a later year.

General reasons for change.—The progressive tax rate structure for individuals is avoided when a grantor creates trusts which accumulate income taxed at low rates, and the income in turn is distributed at a future date with little or no additional tax being paid by the beneficiary, even when he is in a high tax bracket. This result occurs because the trust itself is taxed on the accumulated income rather than the grantor or the beneficiary. This means that the income in question, instead of being added on top of the beneficiary's other income and taxed at his marginal tax rate, is taxed to the trust at the starting tax rate. The throwback rule theoretically prevents this result, but the 5-year limitation and the numerous exceptions seriously erode the basic principle that a beneficiary who receives income from property should pay tax on that income at his (rather than the trust's) marginal rates.

This avoidance device is compounded by the use of multiple trusts—the creation of more than one accumulation trust by the same grantor for the same beneficiary. The splitting of the income among many taxable entities may result in still further reductions of the overall tax burden, since the accumulated income may be taxed to each separate trust at lower rates than would be the case if only one trust were created.[1] Although the use of multiple trusts has been attacked by the Internal Revenue Service, the courts have held that such trusts are valid in some cases.

The tax benefits from splitting income between an individual and one or many trusts can be illustrated by comparing a trust which distributes to a beneficiary currently with the case where an accumulation trust is used, and, finally, with the case where multiple trusts are used. Assume that X creates a trust and contributes $200,000 to it and that under the terms of the trust instrument, the income of the trust is to be distributed each year to X's son, Y. Assume that the $200,000 returns $14,000 in interest income annually and the trust incurs expenses of $400 per year in earning this income. Thus, the net income of the trust, $13,600 is distributed to Y. If Y's other taxable income is $40,000, his additional tax, because of the $13,600 distributed by the trust, will be $8,152.[2]

If, under the terms of the trust instrument, the $13,600 of net income instead of being currently distributed to Y, is to be accumulated and distributed to Y at a future time, the tax would be paid by the trust. In this case, in addition to a deduction for the $400 of expenses, the trust would be allowed a personal exemption of $100. The tax due from the trust on the $13,500 annually would be $3,370, or $4,782 less than the tax due if the income were distributed currently to Y. As a result, the use of the trust to accumulate income would reduce the tax by approximately 59 percent from what it would be if the income were distributed currently to Y.

If, instead of creating one trust and contributing $200,000 to it, X were to create 10 separate trusts and contribute $20,000 to each, the tax benefits would be even greater. In each trust the corpus would be $20,000 and the net income $1,360. Each trust would also have the $100 personal exemption. The tax due from each trust on the $1,360 of net income, less the $100 personal exemption, would be $186.60, and would total $1,866 for the 10 trusts. This would be $1,504 less than the tax in the case of the one accumulation trust, and $6,286 less than the tax due if the income were distributed currently. The tax saving

[1] The creation of multiple entities also serves to increase the number of $100 exemptions allowed to each trust as well as providing for the multiplication of exceptions to the throwback rule, especially advantageous in the case of the $2,000 exemption.

[2] Assumes Y files a separate return and does not take the surcharge into account.

would be substantially greater if a larger corpus and income were used in the example. In this example, the multiple trusts would be taxed at the 16-percent marginal income tax bracket, while the single accumulation trust would be taxed in the 36-percent marginal bracket, and the income distributed currently in the 62-percent marginal bracket.

The committee agrees with the House that taxpayers should not be allowed to utilize accumulation trusts to allow the beneficiaries of the trust either to escape paying tax on the income or to substantially minimize their tax on the income. The committee believes that beneficiaries of these accumulation trusts should be taxed in substantially the same manner as if the income had been distributed to the beneficiaries currently as it was earned. Thus, under the House bill and the committee amendments, the beneficiaries of accumulation trusts will be placed in substantially the same tax status as beneficiaries of trusts which distribute their income currently. This approach is essentially the same treatment as has been applicable to foreign accumulation trusts created by U.S. persons since the passage of the Revenue Act of 1962.

The committee modified the House bill to treat those capital gains of accumulation trusts allocated to the corpus of the trust in a manner similar to ordinary income accumulations. The Committee believes this is necessary to prevent the use of trusts to accumulate capital gains at low rates for future distribution to high tax bracket beneficiaries without any additional tax. It also will reduce the extent to which trust income is taxed to the trust instead of to a beneficiary.

The committee also modified the House bill to provide an interest charge to cover the tax payments by the income beneficiaries which are deferred by the use of accumulation trusts. This interest charge is based on the additional income tax which the beneficiary would have paid if the income originally had been taxed to the beneficiary instead of the trust. The committee believes that this interest charge is necessary because, otherwise, the deferral of the payment of the additional tax (i.e., from the time the income is taxed to the trust until the time when the remainder of the tax is paid on the accumulation distribution by the beneficiary) amounts, in effect, to an interest-free loan to the beneficiary by the government.

Explanation of provision.—Both the House bill and the committee amendments provide that beneficiaries are to be taxed on distributions received from accumulation trusts in substantially the same manner as if the income had been distributed to the beneficiary currently as earned, instead of being accumulated in the trust. The bill eliminates the 5-year limitation and all the exceptions to the throwback rule, and provides an unlimited throwback rule with respect to an accumulation distribution. In this unlimited throwback approach, the bill removes generally the distinctions between treatment of distributions from domestic trusts and those from foreign trusts created by a U.S. person.

In the case of future accumulations of income by trusts, all of their income, other than income distributable currently, is to be taxed to the beneficiary upon its distribution to him. The amounts distributed are to be treated as if they had been distributed in the preceding years in which income was accumulated, but are includible in income of the beneficiary for the current year. However, under the bill the tax on such amounts is to be computed in either of two ways. One method, referred to here as the "exact" method, is substantially the same as the method provided under present law in the case of distributions subject to the "5-year throwback rule." The other is a "shortcut" method which does not require the more extensive computations required by the exact method.

Under the exact method of computation, the tax on the amounts distributed cannot exceed the aggregate of the taxes that would have been payable if the distributions had actually been made in the prior years when earned. This method requires complete trust and beneficiary records for all past years, so that the distributable net income of the trust and the taxes of the beneficiary can be determined for each year. The beneficiary's own tax then is recomputed for these years, including in his income the appropriate amount of trust income for each of the years (including his share of any tax paid by the trust). Against the additional tax computed in this manner, the beneficiary is allowed a credit for his share of the taxes paid by the trust during his life. Any remaining tax then is due and payable as a part of the tax for the current year in which the distribution was received.

The so-called shortcut method in effect averages the tax attributable to the distribution over a number of years equal to the number of years in which the income was earned by the trust. This is accomplished by including, for purposes of tentative computations, a fraction of the income received from the trust in the beneficiary's income for each of the 3 immediately prior years. (The committee amendments modify the short-cut method provided in the House bill to take into account the three years immediately prior to the current year, rather than the current year and the two preceding years, since the inclusion in the short-cut method of the current year in which the trust income for the current year also is taxed, involves a doubling up of income in that year.) The fraction of the income included in each of these years is based upon the number of years in which the income was accumulated by the trust. Thus, if the accumulated income is attributable to 10 different years (although the trust may have been in existence longer than 10 years), then one-tenth of the amount distributed would be included in the beneficiary's income in each of the 3 prior years. The additional tax is then computed with respect to these 3 years and the average yearly additional tax for the 3-year period is determined. This amount is then multiplied by the number of years to which the trust income relates (10 in this example). The tax so computed may be offset by a credit for any taxes previously paid by the trust with respect to such income and any remaining tax liability is then due and payable in the same year as the tax on the beneficiary's other income in the year of the distribution.

The House bill would not have permitted a beneficiary to use the exact method if he was not alive in a year to which part of the trust income which is distributed relates. The committee amendments remove this limitation and allow a beneficiary, who was not alive during a year of the trust in which income was accumulated, to compute the tax on an accumulation distribution under either the exact or the short-cut method as if he were alive then and had no gross income (except from other distributions by accumulation trusts) and no deductions. It is intended that for these purposes such beneficiary shall be deemed to be single, entitled to one exemption, the standard deduction and to be a calendar year taxpayer. Similarly, in the case of a beneficiary which is not a natural person it is intended that both methods of calculation be available and that the foregoing assumptions shall apply, to the extent applicable. Because of this modification the committee amendments allow a beneficiary to use the 3-year average when electing the short-cut method even if the number of trust years to which the income relates is less than 3.

The committee amendments, however, do not allow the "short-cut method" to be used by a beneficiary if during any of his preceding taxable years to which an accumulation distribution was thrown back, prior accumulation distributions also were thrown back by two or more other trusts to the beneficiary. The committee believes this provision is necessary to prevent the creation of multiple trusts with staggered accumulation distributions in order to take advantage of the short-cut rule.

For purposes of averaging the accumulation distribution over the number of years the income was accumulated under the short-cut method, the committee amendments exclude any year in which only a minimum of income was accumulated. This minimum amount is to be 25 percent of the average undistributed net income deemed distributed in any year. For example, if a $10,000 accumulation distribution was made of income accumulated in 10 years, the determination may not include any year in which less than 25 percent of $1,000 ($10,000 divided by 10 years) or $250 was accumulated. For example, if in 2 years less than $250 was accumulated, then, for purposes of the 3-year averaging computation under the short-cut method, the $10,000 would be divided by 8 years (10 years less 2 years disallowed) to determine the average amount deemed distributed each year.

Both versions of the bill require the beneficiary to include in his income for the years involved in the exact or short-cut computations the income previously deemed distributed in such years from prior accumulation distributions (whether from the same trust or another trust). Thus, if a taxpayer has used either the exact or short-cut method in an earlier distribution and uses the exact method for a later distribution, for purposes of this exact computation, any income received from the trust in the earlier distribution must be included in his income for any year to which the second distribution relates, to the extent the earlier distribution was considered distributed in such years. If in the current distribution the taxpayer chooses to use the short-cut method (having used either the exact or short-cut method in prior computations), he is likewise required to include in his income for each of the years involved in the computation (the 3 years for which the average increase in tax is computed) the amounts deemed distributed in such years from any prior accumulation distributions. Furthermore, in the case of two or more accumulation distributions from different trusts received in the same year, the beneficiary is to treat the distributions as having been made consecutively in whichever order he chooses.

As indicated above, the committee amendments also modify the House bill to provide an interest charge to cover the tax payments by the income beneficiary which are deferred (to the extent the taxes may exceed those paid by the trust) by the use of accumulation trusts. This charge is to be the equivalent of what in the average case would be a 6-

percent rate: namely, a 3-percent rate which may not be taken as an income tax deduction. It is based on the amount of tax payable by the beneficiary over and above the tax which was paid in the earlier years by the trust. When an accumulation distribution is made and the beneficiary uses the exact method to compute the tax, the 3-percent simple interest is imposed on each year's additional tax multiplied by the number of years of tax deferral involved (from the year earned until distributed).

When a beneficiary uses the short-cut method to compute the tax, the interest is to be imposed on the additional tax multiplied by the "average" number of years of tax deferral involved. The average number of years is to be determined by adding the total number of deferral years for each yearly accumulation and dividing that total by the number of accumulation years involved. For example, if an accumulation distribution were made in which income had been accumulated in years 8, 6, 4 and 2 of the trust (all income distributed currently in other years) the average number of deferral years would be determined by adding each accumulation year's number of deferral years (20 in this case) and dividing this amount by the number of accumulation years (4 here). Thus, in this case the average would be 5 years. If the additional tax were $2,000, the interest charge would be $300 (3 percent x $2,000 x 5 years).

The committee also modified the House bill to provide an unlimited throwback rule for capital gains allocated to the corpus of an accumulation trust. This provision is not to apply to "simple trusts" (any trust which is required by the terms of its governing instrument to distribute all of its income currently) or any other trusts, which in fact distribute all their ordinary income currently, until the first year they accumulate income. For purposes of this provision, a capital gains distribution will be deemed to have been made only when the distribution is greater than all of the accumulated ordinary income. If the trust has no accumulated ordinary income or capital gains, or if the distribution is greater than the ordinary income or capital gain accumulations, then to this extent it will be considered a distribution of corpus and no additional tax will be imposed.

Capital gains are to be taken into account separately in determining the additional tax payable by the beneficiary. If the exact method is used to compute the tax, the capital gains distribution is thrown back to the earliest year of the accumulated capital gains to the extent of the undistributed capital gains for that year, and then to each of the succeeding years, in a like manner. If, however, the shortcut method is used, only the years in which there were capital gains are to be taken into account for purposes of determining the average number of years involved. In the case of capital gain accumulations, no interest charge is to be imposed.

Where the payments by the trust exceed the aggregate tax due with respect to any year, these payments may offset amounts payable by the same beneficiary with respect to other years and may reduce or eliminate interest charges to him with respect to other years. Furthermore, where the taxes paid by the trust are in excess of any amounts that would have been paid by the beneficiary if the income had been distributed currently (plus the interest), then the excess taxes are to be allowable as a credit to the beneficiary in the taxable year in which the accumulation distribution is required to be included in his gross income. Any excess over the total tax liability of the beneficiary is to be treated as an overpayment of tax by the beneficiary, in which case a refund would be available. In the case of a beneficiary who uses the exact method, however, a credit is not to be allowed for any taxable year of the trust before the beneficiary was born or created (if another trust or a person other than a natural person).

Under the House bill, the alternative methods of tax computation outlined above were substitutes for including and taxing the entire amount of the distribution in the year actually received. The committee amendments revise this computation to require the use of one of the alternative methods to compute the tax on the trust distribution. This means that a partial tax which includes the special interest is to be computed on the beneficiary's taxable income (other than the accumulated income distributed by the trust) and a partial tax is to be computed on the accumulated income by the use of one of the alternative methods. A partial tax is also to be computed by one of the alternative methods (without the special interest) on the distribution of accumulated capital gains. The sum of these partial taxes will be the beneficiary's total tax liability for the year in which he received a distribution of accumulated income. In no event is the partial tax on the accumulation distribution plus the special interest to exceed the amount of the accumulated income distributed.

Since the use of one of the alternative methods of computing the tax on a distribution of accumulated income is required under the committee amendments, the beneficiary must supply such information regarding his income for each of the years in which an amount is considered distributed, as the Secretary or his delegate requires by regulations. However, in the case where an individual uses the "exact method" but doesn't have all his records during the years he was a minor, then, if a tax return was not required for any year during his minority, it will be presumed that he filed a return and had no gross income (except from other distributions by accumulation trusts) and no deductions in those taxable years.

If the adequate information regarding the trust is not available to determine the amounts deemed distributed in any preceding taxable years, then all accumulated income of the trust for such years will be considered as distributed on December 31, 1969, or the earliest subsequent date upon which it can be shown to the satisfaction of the Secretary or his delegate that the trust was first in existence.

The trust will continue to be taxed, as at present, when the income is earned, and subsequently, when the beneficiary is taxed on the income at the time of distribution, he would be able to claim credits for the taxes previously paid by the trust on this income. The bill, however, changes the method for allowing a credit to the beneficiary for taxes paid by the trust where the accumulation distribution deemed made for a previous year is less than the undistributed net income of that year. The bill provides that the credit allowed to the beneficiary for taxes paid by the trust will be the same amount as the taxes deemed distributed to the beneficiary. This means, as under present law, that when all of the undistributed net income of a preceding taxable year of the trust is deemed distributed, then all of the taxes paid by the trust with respect to such income (excluding that attributable to the capital gains) will be allowed as a credit to the beneficiary. However, when less than all of the undistributed net income of a preceding taxable year is deemed distributed, then the credit allowable to the beneficiary will be the same as the taxes deemed distributed to the beneficiary, which will be the pro rata portion of the taxes imposed on the trust with respect to such income. This change from existing law (which allows a credit in the amount of taxes the trust would not have paid had the amount deemed distributed actually been paid out in the earlier year) provides for considerable simplification by eliminating the technical complexity required by separate computations for the credit and taxes deemed distributed.

In the case where there is a throwback under the new provisions to the same year for which there was a previous throwback under existing law and a partial credit had been allowed for taxes imposed on the trust under existing law, the new rules will apply. Under the new provision, the starting point for both the taxes deemed distributed and the credit allowed will be the taxes originally imposed on the trust, less the total credits previously allowed. Thus, to the extent the credit previously allowed under existing law had exceeded the taxes deemed distributed, the excess will not be deemed distributed to the beneficiary, and the remaining taxes imposed on the trust (the uncredited portion of the original tax) will be deemed distributed and credited to the beneficiary pro rata as and when the remaining undistributed net income of that year is deemed distributed.

The House provision would have applied to income accumulated by a trust (other than a foreign trust created by a United States person) in years ending after April 22, 1964, where the accumulated income was distributed to the beneficiaries after April 22, 1969. The committee amendments modify this to apply the new provision only to accumulations in taxable years beginning after December 31, 1968, with respect to distributions made after that date. Income accumulated in prior years, regardless of when distributed, is to continue to be subject to the law in effect at the time the income was accumulated except for the fact that the $2,000 de minimis exemption is made inapplicable to any distributions after December 31, 1968.

This means that for taxable years of a trust beginning after December 31, 1973, at which time the present law five-year throwback and the exceptions would not apply to accumulations made before December 31, 1968, the new rules will be in effect for all trusts and will apply to accumulations made only after December 31, 1968. All income and capital gains accumulated prior to this date will be treated as part of the corpus of the trust.

The committee amendments modify the unlimited throwback computation in determining the years to which the accumulated income relates for accumulations made under the new rules as well as accumulations still subject to the old rules. For purposes of computing the tax when an accumulation distribution is made, the income is to be treated as coming from the earliest years first, to the extent of the accumulated income in those years. (Under present law, the 5-year throwback computation treats the income as coming from the years immediately preceding the distribution.) This change is intended to ease the administrative burden of trust accounting in that all the earlier years will be closed out first so that the trust will not have to go further and further back in making is computations each time it makes an accumulation distribution. Under the new computation rules, the trust will always be coming forward to pick-up years of accumulated income.

The committee amendments also provide that, if the fiduciary of the trusts elects, a distribution within the first 65 days of a trust's taxable year will be considered as distributed during the preceeding taxable year. This amendment is intended to give the trustee time to determine the amount of income earned by the trust and an opportunity to distribute it.

Both versions of the bill provide that in the case of a trust created by a taxpayer for the benefit of his spouse, the trust income which may be used for the benefit of the spouse is to be taxed to the creator of the trust as it is earned. However, this provision is not to apply where another provision of the Code requires the wife to include in her gross income the income from a trust.

Effective date.—These provisions are to apply to accumulations made in taxable years beginning after December 31, 1968. In the case of trust income for the benefit of a spouse, the new provision is to apply only with respect to property transferred in trust after October 9, 1969.

Revenue effect.—It is estimated that these provisions will result in a revenue gain of $10 million in 1970, $35 million in 1972, $60 million in 1974 and $130 million in the long run.

J. MULTIPLE CORPORATIONS

(Sec. 401 of the bill and secs. 1561–1564, 46, 48, 179, and 804 of the code)

Present law.—Under present law, corporations generally are taxed at the rate of 22 percent on the first $25,000 of taxable income and at 48 percent on taxable income in excess of $25,000. The lower tax rate on the first $25,000 of taxable income is commonly referred to as the surtax exemption. The surtax exemption was adopted to benefit small corporations. However, large business enterprises have been able to receive considerable tax benefits through the use of multiple corporations.

Present law limits to some extent the ability of a taxpayer to split his business enterprise into a number of corporations so as to obtain multiple surtax exemptions by providing that a "controlled group" of corporations is limited to one surtax exemption.

Instead of claiming one surtax exemption for the group of corporations, however, a controlled group may elect for each member to take a surtax exemption if each of the corporations pays an additional 6 percent tax on the first $25,000 of its taxable income.[1] This generally reduces the tax savings of the surtax exemption from $6,500 to $5,000.

A "controlled group" is defined under present law to include three principal categories of affiliated groups of corporations:

(*a*) Parent-subsidiary controlled group: One or more chains of corporations connected with a common parent corporation through 80 percent or more stock ownership (determined by voting power or value).

[1] The election to take multiple surtax exemptions and to pay the additional 6 percent tax is generally der : where the group has a combined income of about $32,500 or more. Below this fi allocation of a single surtax generally produces a lower tax.

(*b*) Brother-sister controlled group: Two or more corporations each of whose stock is owned 80 percent or more (by voting power or value) by one individual, estate, or trust.

(*c*) Combined group: Three or more corporations, each of which is a member of a parent-subsidiary group or a brother-sister group, and one of which is a common parent corporation.

In addition to the surtax exemption, there are other provisions of present law designed to aid small businesses, but which may be taken advantage of to some degree by large organizations through the use of multiple corporations. These other provisions include: (1) the provision which allows a corporation to accumulate $100,000 of earnings without being subject to the penalty tax on earnings unreasonably accumulated to avoid the dividend tax on shareholders; (2) the life insurance company small business deduction of 10 percent of the company's net investment income (limited to $25,000 per year); and (3) the provision which allows an additional first year depreciation allowance equal to 20 percent of the cost of the property (limited to $10,000 per year).

General reasons for change.—Although the surtax exemption and other tax provisions discussed above were designed to help small businesses, large organizations have been able to obtain substantial benefits from these provisions by dividing the organization's income among a number of related companies. The committee agrees with the House that large organizations which operate through multiple corporations and which are not in reality "small businesses" should not be allowed to receive the substantial and unintended tax benefits resulting from the multiple use of the surtax exemption and these other provisions. This is true whether or not the businesses have been separately incorporated for business, as distinct from tax, reasons.

Explanation of provisions.—The House bill and the committee amendments provide that a group of controlled corporations may have only one each of a series of special provisions designed to aid small corporations. The most important of these are the surtax exemption and the accumulated earnings credit. A controlled group of corporations is to be limited to one $25,000 surtax exemption and one $100,000 accumulated earnings credit after a transition period.

The House bill provided an 8-year transition period, reducing the additional surtax exemptions in excess of one by one-eighth (or $3,125) in each of the years 1969 through 1976. The additional $100,000 accumulated earnings credits were similarly reduced. The committee amendments reduce this transition period to 5 years but commence it with the year 1970. Thus, under the committee amendments the additional surtax exemptions in excess of one are to be reduced by one-fifth (or $5,000) for each of the years 1970 through 1974. Similarly, the additional accumulated earnings credits are to be reduced by one-fifth (or $20,000) for each of these years. A change in the surtax exemption under this amendment is not a change in tax rates for purposes of section 21 of the code.

For taxable years beginning after December 31, 1973, a controlled group of corporations is to be limited to one $25,000 surtax exemption and one $100,000 accumulated earnings credit.

During the transition period, the 6 percent additional tax presently imposed on the first $25,000 of income of each corporation of a controlled group which claims multiple surtax exemptions is to continue to apply but it is to be imposed only with respect to the amount of each corporations' income subject to the reduced additional surtax exemption.

The committee modified the transition rule of the House bill under which a controlled group of corporations may gradually increase the dividend received deduction allowed members of the group from 85 percent to 100 percent. The committee amendment allows a phase in at a rate of 3 percent per year. The House bill had provided for a phase in of 2 percent per year. Both versions of the bill allow the gradually increasing deduction even though the group is claiming the additional, (but reduced) surtax exemptions, during the transition period. This rule phases in the 100 percent dividends received deduction in step with the reduction in the additional surtax exemptions. To avail itself of this provision, a controlled group of corporations must have in effect an election under section 1562(a) to claim multiple surtax exemptions which was made on or before April 22, 1969, and the dividends must be paid out of earnings and profits of a taxable year including a December 31 after 1969 but before 1974.

Under present consolidated return regulations, preconsolidation losses for a corporation in a group claiming multiple surtax exemptions may be carried over after consolidation only against the income of the corporation which sustained the losses. The House bill would have permitted net operating losses for taxable years ending on or after December 31, 1969, to be taken as a deduction against income of other members of such group in the same proportion as the reduction in the additional surtax exemptions for the group. The committee amendments do not permit any preconsolidation losses during the transition period to be carried over and used against the income of other members of the group.

The committee amendments, however, allow corporations which had elected multiple surtax exemptions (under section 1562) to shift immediately to the consolidated return basis of reporting (foregoing any part of the additional surtax exemptions during the transition period) and to use loss carryovers within the group without reduction (i.e., against income of other members of the group) if the group agrees to give up the multiple surtax exemptions it had claimed for the year in which the loss was sustained and all intervening years. To avail itself of this provision, the group must file a consolidated return for the taxable year which includes December 31, 1970.

Both versions of the bill modify the present definition of a brother-sister controlled group—i.e., two or more corporations 80 percent or more of the stock of which is owned (by voting power or value) by one individual, estate, or trust. The bill expands the definition to include two or more corporations which are owned 80 percent or more (by voting power or value) by five or fewer persons (individuals, estates, or trusts) providing that these five or fewer persons own more than 50 percent of each corporation identically. For example, a person who owns 70 percent of one corporation and 30 percent of another corporation is to be treated as owning only 30 percent of each corporation identically. It is only this amount which would be taken into account in applying the 50 percent test.

To eliminate the possibility of avoiding the percentage ownership requirements by transferring stock to a tax-exempt organization which the taxpayer or related parties control, the bill disregards, for purposes of the percentage ownership test, stock owned by a tax-exempt organization which is controlled by the taxpayer, or related parties.

The bill also places a limitation on the multiple use controlled groups of corporations of other tax benefits which are designed to aid small businesses. Present law limits multiple use of these benefits only in the case of an affiliated group of corporations (which, in general, is a parent-subsidiary controlled group). Thus, under the bill, members of all controlled groups of corporations are to be treated as one taxpayer for purposes of determining the additional first-year depreciation deduction. The investment eligible for the first year additional depreciation deduction is to be apportioned among the component members of a controlled group in the manner prescribed by regulations. A controlled group also is to be allowed an investment credit equal only to its aggregate tax liability up to $25,000 plus 50 percent of the group's tax liability above $25,000. In addition, the group would be allowed an investment credit only with respect to $50,000 of used property. There will be no special transition rules with respect to these changes. The $25,000 and $50,000 amounts will be apportioned among the component members of such group in a manner prescribed by regulations. For purposes of the additional first-year depreciation deduction and the $50,000 used property limitation under the investment credit, the term "controlled group" has the same meaning assigned to it by section 1563(a), except that a 50 percent, rather than 80 percent, test is used.

A controlled group of corporations also is to be limited to one $25,000 life insurance company small business deduction. To ease the transition on those companies subject to this change, the bill provides that the additional small business deductions allowed individual members of a controlled group in excess of one are to be reduced at the same rate as the additional surtax exemptions are reduced in each of the years 1970 through 1974; namely, by one-fifth ($5,000).

The committee amendments delete from the House bill a provision limiting the tax benefits of controlled groups of mutual insurance companies. This provision is deleted since it is understood that there are no such groups in existence.

Effective date.—The limitation of controlled groups to one surtax exemption, one accumulated earnings credit and one small business deduction, subject to transition rules, are to apply to taxable years beginning after December 31, 1973. Transition rules are to apply to taxable years beginning after December 31, 1969. The changes in the definition of a controlled group are to apply with respect to taxable years ending on or after December 31, 1970. The exclusion from the control test of stock owned by a tax-exempt organization which is controlled by the taxpayer, or related parties, is to be effective with respect to taxable years ending on or after December 31, 1970. Likewise, the limitation on multiple tax benefits with respect to the investment credit and the additional first-year depreciation deduction are to be effective with respect to taxable years ending on or after December 31, 1970.

Revenue effect.—Revenue increases under these amendments are estimated at $30 million the first year and $235 million after the provision becomes fully effective in 1974.

K. CORPORATE MERGERS, ETC.

1. Disallowance of Interest Deduction in Certain Cases (secs. 411 and 415 of the bill and secs. 279 and 385 of the code)

Present law.—Under present law a corporation is allowed to deduct interest paid by it on its debt but is not allowed a deduction for dividends paid on its stock or equity.

General reasons for change.—It is a difficult task to draw an appropriate distinction between dividends and interest, or equity and debt. Even though a corporate obligation is labeled debt, it may be treated for tax purposes as equity, the payments on which accordingly are nondeductible dividends, if, in fact, the obligation represents an equity interest in the corporation. Some of the factors which may lead to the classification of a "debt obligation" of a corporation as equity include whether or not the bond or debenture is subordinated to the corporation's other creditors, whether or not the bond or debenture is convertible into stock of the corporation, and whether the corporation's debt-equity structure is such that it is reasonable to expect that it will be able to meet its obligations to pay the principal and interest on the bond or debenture when due.

Although the problem of distinguishing debt from equity is a longstanding one in the tax laws, it has become even more significant in recent years because of the increased level of corporate merger activities and the increasing use of debt for corporate acquisition purposes.

There are a number of factors which make the use of debt for corporate acquisition purposes desirable, including the fact that the acquiring company may deduct the interest on the debt but cannot deduct dividends on stock. A number of the other factors which make the use of bonds or debentures desirable are also the factors which tend to make a bond or debenture more nearly like equity than debt.[1] For example, the fact that a bond is convertible into stock tends to make it more attractive since the convertibility feature will allow the bondholder to participate in the future growth of the company. The fact that a bond is subordinated to other creditors of the corporation makes it more attractive to the corporation since it does not impair its general credit position.

Although it is possible to substitute debt for equity without a merger, this is much easier to bring about at the time of the merger. This is because, although stockholders ordinarily would not be willing to substitute debt for their stock holdings, they may be willing to do so pursuant to a corporate acquisition where they are exchanging their holdings in one company for debt in another (the acquiring) company.

The committee agrees with the House that in many cases the characteristics of an obligation issued in connection with a corporate acquisition make the interest in the corporation which it represents

[1] The acquiring corporation obtains a stepped-up basis for the assets or stock acquired. The other party obtains some certainty of an income return and repayment. However, such debt often has nontax characteristics which give it some of the nature of stock.

more nearly like a stockholder's interest than a creditor's interest, even though the obligation is labeled as debt. In view of the increasing use of debt for corporate acquisition purposes and the fact that the substitution of debt for equity is most easily accomplished in this situation, the committee also agrees with the House that it is appropriate to take action in this bill to provide rules for resolving, in a limited context, the ambiguities and uncertainties which have long existed in our tax law in distinguishing between a debt interest and an equity interest in a corporation. In general, the committee has adopted the House's approach to this problem where a corporate acquisition is involved.

In view of the uncertainties and difficulties which the distinction between debt and equity has produced in numerous situations other than those involving corporate acquisitions, the committee further believes that it would be desirable to provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise. The differing circumstances which characterize these situations, however, would make it difficult for the committee to provide comprehensive and specific statutory rules of universal and equal applicability. In view of this, the committee believes it is appropriate to specifically authorize the Secretary of the Treasury to prescribe the appropriate rules for distinguishing debt from equity in these different situations.

Explanation of provision.—For the above reasons, the committee has added a provision to the House bill which gives the Secretary of the Treasury or his delegate specific statutory authority to promulgate regulatory guidelines, to the extent necessary or appropriate, for determing whether a corporate obligation constitutes stock or indebtedness. The provision specifies that these guidelines are to set forth factors to be taken into account in determining, with respect to a particular factual situation, whether a debtor-creditor relationship exists or whether a corporation-shareholder relationship exists. The provision also specifies certain factors which may be taken into account in these guidelines. It is not intended that only these factors be included in the guidelines or that, with respect to a particular situation, any of these factors must be included in the guidelines, or that any of the factors which are included by statute must necessarily be given any more weight than other factors added by regulations. The factors specifically listed are as follows:

(1) Whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest;

(2) Whether there is subordination to or preference over any indebtedness of the corporation;

(3) The ratio of debt to equity of the corporation;

(4) Whether there is convertibility into the stock of the corporation; and

(5) The relationship between holdings of stock in the corporation and holdings of the interest in question.

In developing these guidelines, the Secretary of the Treasury is not to be bound or limited by the specific rules which the committee amendments and the House bill provide for distinguishing debt from equity in the corporate acquisition context. Thus, an obligation the interest on which is not disallowed under the corporate acquisition section nevertheless might be found to constitute equity (and hence the interest disallowed) under the general debt-equity regulatory guidelines. Moreover, unlike the rules provided by the bill in a corporate acquisition context, which deal only with the allowability of the interest deduction, the guidelines to be promulgated by the Secretary of the Treasury are to be applicable for all purposes of the Internal Revenue Code.

As previously indicated, the House bill and the committee amendments also provide specific rules for determining whether an obligation constitutes debt or equity insofar as the allowability of the interest deduction is concerned in the corporate acquisition context. It is provided that a corporation is not to be allowed in interest deduction (either for stated interest or unstated interest such as original issue discount) with respect to certain types of indebtedness (indebtedness as used here means any obligation evidenced by a bond, debenture, note or certificate, or other evidence of indebtedness issued by the corporation) which it issues as consideration for the acqusition of stock in another corporation, or the acquisition of assets of another corporation.

In the case of an asset acquisition, the House bill provided that the interest disallowance rule applied only if at least two-thirds of the total value of all the assets of a corporation were acquired pursuant to a plan of acquisition. In order to prevent this test from being avoided where a large proportion of the assets of the acquired company consists of cash or nonoperating properties, the committee amendments provide that the two-thirds test is to be applied with respect to the assets (other than money) of the acquired company which are used in trades or businesses carried on by it, rather than with respect to the company's total assets. An asset which will be used in a corporation's trade or business is to retain this status even though it is temporarily not actually used in the business.

The types of indebtedness to which the limitation on the interest deduction provided under the House bill and the committee amendments apply are obligations which meet each of three tests, namely, the subordination test, the convertibility test and the debt-equity or interest coverage test.

The subordination test contained in the House bill required that the obligation must be subordinated to the claims of the trade creditors generally of the issuing corporation. The committee believes that the subordination test should also be considered met where an obligation, although not subordinated to the corporation's trade creditors generally, is subordinated to any substantial amount of the corporation's unsecured indebtedness. Accordingly, the committee amendments provide that the subordination test is to be satisfied if the obligation either is subordinated to the claims of trade creditors of the issuing corporation generally or is expressly subordinated in right of payment to any substantial amount of the corporation's unsecured indebtedness (whether outstanding or subsequently issued).

An obligation is to be considered expressly subordinated whether the terms of the subordination are provided in the evidence of indebtedness itself or in a side agreement and whether the subordination relates to interest or principal or both, but is not to be so considered if the subordination occurs solely by operation of law, such as in the case of bankruptcy laws.

Under the convertibility test contained in the House bill and the committee amendments, it is required that the obligation either must be directly or indirectly convertible into the stock of the issuing corporation or the obligation must be part of an investment unit or other arrangement which also includes an option to acquire, directly or indirectly, stock of the issuing corporation. Thus, the convertibility test is satisfied if warrants to purchase the stock of the corporation are issued in conjunction with the obligation.

The debt-equity and interest coverage limits—which generally are to be applied as of the last day of a taxable year in which an obligation is issued for the specified acquisition purposes—would be exceeded under the House bill with respect to an obligation either if the debt-equity ratio of the issuing corporation was in excess of 2 to 1 or if the annual interest expense to be paid by the issuing corporation on its total indebtedness was not covered at least three times over by its projected earnings.

The committee believes that the ratios specified in the House bill for the debt equity and interest coverage tests are unduly restrictive. Accordingly, in order to more appropriately reflect a reasonable capital structure for a corporation, the committee amendments provide that the debt equity ratio of the issuing corporation must be in excess of 4 to 1 in order for the debt equity limit to be exceeded and also provide that the interest coverage limitation is exceeded only where the issuing corporation cannot cover the annual interest expense to be paid by it on its total indebtedness at least two times over by its projected earnings.

The debt-equity ratio of the issuing corporation for purposes of this test generally is determined by comparing the corporation's total indebtedness with the excess of its money and other assets over that indebtedness. Its assets are taken into account for this purpose at their adjusted basis for purposes of determining gain.

The annual interest coverage alternative of the third test generally is to be applied by comparing the average annual earnings of the issuing corporation for the 3-year period ending with the last day of the taxable year for which the determination is being made with the corporation's annual interest costs on its total indebtedness as of the time of determination. For this purpose the average annual earnings, generally, means the corporation's earnings and profits computed, however, without reduction for interest, Federal income tax liability or dividends paid (other than dividends paid from the acquired to the acquiring corporation). Where the issuing corporation has either acquired control—as defined for purposes of the reorganization provisions of the code—of the acquired company or has acquired substantially all of the properties of the acquired company, then the annual interest coverage test is to be determined with respect to the average annual earnings and the annual interest cost of both corporations combined.

In order to clarify the application of the debt-equity ratio and interest coverage tests in the case of financial institutions in the manner which the committee believes was intended by the House, the committee amendments provide specific rules for purposes of applying these tests in the case of banks and corporations primarily engaged in a lending or finance business. For this purpose, a lending or finance business means a business of making loans or purchasing or discounting accounts receivable, notes, or installment obligations.

In determining the debt equity ratio of a bank or lending or finance company, the committee amendments provide that the bank's or the company's total indebtedness is to be reduced by the total amount of indebtedness owed to the company which arises out of the banking business or the lending or finance business. The assets of the bank or company also are to be reduced by this amount since the bill defines a company's equity in terms of the excess of its assets over its indebtedness.

In determining the annual interest expense of a bank or a lending or finance company, the committee amendments, in effect, provide that the interest expense on its indebtedness which is used in the banking or the lending or finance business is not to be taken into account. The amount of its interest expense not taken into account for this purpose is that part of the corporation's total interest expense which is proportionate to that part of the corporation's total indebtedness which is not taken into account for purposes of the debt-equity test. A similar reduction is to be made in determining the corporation's projected earnings.

These rules regarding the application of the debt-equity and interest coverage test also are to apply if the bank or the lending or finance company is a member of an affiliated group of corporations (whether or not it is the issuing corporation). In this case, however, the rules are to be applied only for purposes of determining the debt, equity, interest expense, and projected earnings of the bank or lending or finance company which then are taken into account in determining the debt-equity ratio and annual interest coverage of the affiliated group as a whole. In other words, these rules are to be applied to reduce the bank's or the lending or finance company's debt, interest expense, and projected earnings which are taken into account with respect to the group, but are not to reduce the debt, interest expense or projected earnings of other corporations in the affiliated group.

In determining whether a company which is a member of an affiliated group is "primarily engaged in a lending or finance business," only the activities of the company—not those of the whole group—are to be taken into account. The above principles also are to be applied in cases where the projected earnings and annual interest expense of both the issuing corporation and the acquired corporation are taken into account under the bill for purposes of the interest coverage test.

An interest deduction is not to be disallowed under the bill with respect to obligations issued for the specified acquisition purposes, even where the obligations meet the three tests provided by the bill, for up to $5 million per year of interest costs on these obligations. This $5 million exception for any year, however, is to be reduced to the extent of any interest paid by the issuing corporation on obligations which are issued for the specified acquisition purposes but which are not subject to the disallowance rule of the bill, whether the obligations were issued in the past or are issued in the future. The committee believes that it is appropriate to limit the obligations which are taken into account for this purpose to obligations issued in the recent past, rather than to all past obligations as provided by the House bill. Accordingly, the committee amendments provide that $5 million exception is to be reduced by interest paid by the issuing corporation on obligations which are issued after 1967 for the specified acquisition purposes but which are not subject to the disallowance rule of the bill.

Obligations issued for the specified acquisition purpose after 1967 but before October 10, 1969, are to be included within the category of obligations which cause a reduction in the $5 million exception, whether or not these obligations meet the three specific tests provided by the bill, since the disallowance rule of the bill only applies to obligations issued after October 9, 1969. The term "issued" includes the giving of a note to a bank or other lender as well as the issuance of a bond or debenture. In addition, as is generally provided for purposes of the disallowance rule, the extension, renewal, or refinancing of an obligation is not to be considered the issuance of a new obligation. Thus, the interest on an obligation issued to refinance a pre-1968 obligation used for corporate acquisition purposes is not to be taken into account as a reduction of the $5 million exception.

In the case of obligations issued for the specified acquisition purposes after October 9, 1969, the $5 million exception is to be reduced by the interest on any obligation which is not subject to the disallowance rule provided by the bill. Included within this category are obligations which do not meet one of the three specified tests; obligations used to acquire foreign corporations; obligations which are no longer subject to the disallowance rule because of the special 3-year rule discussed below; and obligations which qualify for the 5 percent stock rule discussed below. Also included within this category would be obligations issued under the transition rules discussed below.

The House bill and the committee amendments provide that the interest deduction with respect to obligations issued for the specified acquisition purposes which meet all three tests is to be disallowed starting with the first taxable year of the corporation as of the last day of which the debt-equity or annual interest coverage test is met. As a general rule, once the tests prescribed by the bill are satisfied with respect to an obligation, so as to result in the disallowance of a deduction for the interest with respect to the obligation for a taxable year, the interest deduction will be disallowed for all subsequent taxable years.

Where, however, the issuing corporation subsequently obtains control of, or acquires substantially all the properties of, another corporation, and, as a result, by applying the debt-equity or annual interest coverage test as of the end of the year in which control, or the properties, are acquired and by taking the annual interest expense and projected earnings of both corporations into account for purposes of the annual interest coverage alternative of the test, the limits provided in the test are no longer exceeded, then the interest deduction is to be allowed for that taxable year and subsequent taxable years.

Under the House bill, there was no way other than that just discussed for a corporation to have the interest deduction restored with respect to obiligations it had issued, even where its capital structure had been improved so that the debt-equity and interest coverage tests were satisfied for a substantial period of time. The committee believes that it is appropriate to restore the interest deduction in this type of case. Accordingly, the committee amendments provide that if an issuing corporation has the appropriate debt-equity ratio and interest coverage for each of three consecutive taxable years, then the disallowance rule is to cease to apply with respect to previously issued obligations of the corporation commencing with the first taxable year after the three-year period.

The rules provided by the House bill and the committee amendments do not apply with respect to tax-free acquisitions by the issuing corporation of stock of a newly formed subsidiary or of stock of an existing subsidiary (i.e., a corporation which the issuing corporation theretofore controled within the meaning of section 368(c)).

An exception also is provided to the interest deduction disallowance rule of the bill for indebtedness issued in connection with the acquisition of assets or stock of a foreign corporation, if substantially all of the income of the foreign corporation for the 3 years prior to the acquisition was from foreign sources.

In order to eliminate de minimis stock acquisitions from the scope of the disallowance rule, the committee amendments provide that this rule is to apply to obligations issued to acquire stock a company, only if the issuing corporation has owned 5 percent or more of the total combined voting power of the other corporation at any time between October 9, 1969, and the close of the taxable year in which the stock acquisition occurs.

Where the issuing corporation is a member of an affiliated group (as determined under section 1504(a) without any exclusion under section 1504(b)), the tests prescribed by the bill are in general to be applied by treating all members of the affiliated group as one entity, i.e., by treating the group as the issuing corporation. The company whose stock is being acquired, however, is not to be treated as a member of the affiliated group (even if it otherwise would be considered a member of the group) and thus an acquisition of its stock (including stock held by a minority shareholder) would be subject to the interest deduction disallowance rule.

The extension, renewal, or refinancing of an existing obligation is not to be considered the issuance of a new obligation. Thus, if the interest deduction is disallowed under the rules of the bill with respect to an obligation, the disallowance is to continue even though the obligation is extended, renewed, or refinanced. In addition, the bill provides that the interest deduction disallowance rule is to continue to apply if a corporation, other than the issuing corporation, becomes liable on an obligation as guarantor, endorser, or indemnitor, or assumes liability for the obligation.

For purposes of applying other provisions of the Internal Revenue Code, the bill provides that no inference is to be drawn from these rules as to whether any obligation which the issuer terms a bond, debenture, note, certificate or other evidence of indebtedness is, in fact, indebtedness of the issuer.

Effective date.—The House bill provided that this provision was to apply with respect to interest paid or incurred on indebtedness incurred after May 27, 1969. Under the committee amendments the provision is to apply with respect to indebtedness incurred after

October 9, 1969. The committee amendments further provide that this provision is to be inapplicable, even though an obligation is issued after October 9, 1969, in two types of transition situations where the transaction had previously been undertaken. The provision is not to apply to obligations issued to acquire stock or assets of a corporation pursuant to a binding contract in effect on October 9, 1969.

In addition, where the issuing corporation as of October 9, 1969, had at least a 50 percent voting interest in another corporation, this provision is not to apply to obligations issued by the corporation to acquire the additional stock in the other corporation which is necessary to give the acquiring corporation control (i.e., an 80 percent interest) of the other corporation, but only to that extent. If obligations are issued to acquire a greater amount of stock than is necessary for this purpose, only the proportionate part of the obligations related to the acquisition of that part of the stock acquired which is necessary to provide control is to be eligible for this treatment. This will allow a corporation which had achieved practical control of another corporation by October 9, 1969, to acquire the additional stock necessary to give it control for tax purposes.

2. Limitation on Installment Sales Provision (sec. 412 of the bill and sec. 453(b) of the code)

Present law.—Under present law, a taxpayer may elect the installment method of reporting a gain on a sale of real property, or a casual sale of personal property where the price is in excess of $1,000. The installment method, however, is available only if the payments received by the seller in the year of sale (not counting debt obligations of the purchaser) do not exceed 30 percent of the sales price.

Although the Internal Revenue Service has not ruled as to whether the installment method of reporting gain is available where the seller receives debentures of the purchaser, it is understood that some tax counsel have advised that the method is so available.

General reasons for change.—The allowance of the installment method of reporting gain in the case where debentures of the purchaser are received by the seller of the property is another aspect of the tax laws which has increased in significance in recent years as a result of the increasing merger activity.

A stock-for-stock or stock-for-assets acquisition of a corporation which qualifies under the reorganization provisions of the code (sec. 368) is treated as a tax-free exchange. However, where the stock of a corporation is acquired by exchanging debentures of the acquiring corporation for that stock, the exchange is not tax free. In other words, the shareholders of the acquired corporation generally are treated as receiving taxable gain in the amount by which the value of the debentures received by them exceeds their basis for the stock exchanged. Much the same tax-free effect, however, is achieved by the former shareholder if he is permitted to report the gain on the installment method.

The committee agrees with the House that Congress did not originally intend the installment method to be available where the seller receives debentures or other readily marketable securities. Moreover, the committee agrees that allowing the installment method in this situation is not consistent with the purpose underlying the installment provisions. The installment method of reporting gain presumably was initially made available because of the view that where the seller received a debt obligation he did not have cash in hand, or the equivalent of cash, which would provide him with funds to pay the tax due on the gain. Debentures, however, in most cases can be readily traded on the market and therefore are a close approximation of cash. Thus, the problem of the seller not having the cash with which to pay the tax due would not appear to be present where he receives debentures or other readily marketable securities.

In addition to providing for the treatment of debentures or other readily marketable securities under the installment method of reporting gains, the House bill also would have denied the use of the installment method unless the payment of the loan principal, or the payment of the loan principal and interest together, were spread relatively evenly over the installment period. Since this would be a significant departure from existing law, the committee believes it could have an undesirable effect on legitimate commercial transactions where payment is deferred because of the purchaser's lack of ability to make immediate payment. This is especially true in view of the widespread application of this rule which could affect sales of real estate and a wide variety of sales of personal property. Accordingly, the committee has deleted the periodic payment requirement contained in the House bill.

Explanation of provision.—For the reasons described above, the House bill and the committee amendments provide that for purposes of the installment method of reporting gains on sales of real property and casual sales of personal property, certain types of indebtedness are to be treated as payments received in the year of sale. Thus, these types of bonds or debentures are to constitute income to the seller in the year of sale and also are to be taken into account for purposes of the requirement which denies use of the installment method where more than 30 percent of the sales price is received in the year of sale.

The type of indebtedness to be treated in this manner are bonds or debentures with interest coupons attached, in registered form, or in any other form designed to make is possible to readily trade them in an established securities market. Bonds or debentures are to be considered designed to be readily tradeable if steps necessary to create a market for the security are taken at the time of issuance (or later, if taken pursuant to an agreement or understanding which existed at the time of issuance) or if the bonds or debentures are part of an issue which will normally be traded through brokers dealing in corporate or government securities. Under the committee's bill this treatment is extended to an additional type of bond; namely, one which is payable on demand. The committee believes that this type of indebtedness also is essentially the equivalent of cash and should be so treated for installment sales purposes.

The committee amendments also provide that bonds in registered form which the taxpayer establishes will not be readily tradeable in an established securities market are not to be treated as payments received in the year of sale, since because of their lack of ready marketability they do not possess the characteristics which would render them essentially similar to cash. A bond or debenture which will normally be traded through brokers dealing in corporate or government securities is to be treated as being readily tradeable in an established securities market.

A bond or debenture ordinarily is to be considered in registered form if it is issued in a series under a trust indenture and if it cannot be transferred without changing the ownership registration on the registration books of the corporation. The committee does not intend that ordinary promissory notes are to be included within the category of indebtedness which is treated as payments received in the year of sale, even though it is possible for these notes to be assigned by one party to another party.

Although the problem to which this provision is directed has been highlighted by the debentures issued in connection with corporate acquisitions, and probably will have its major effect in these transactions, the committee agrees with the House that this provision should not be restricted in application to these situations. This is because the rationale for the provision essentially is that there is no reason for postponing the gain where a seller of property receives something which is the equivalent of cash. Thus, this provision of the bill is to be applicable in the case of bonds or debentures issued either by a corporation or by a government or political subdivision thereof and is to be applicable regardless of the type of transaction in which the bonds or debentures are received.

Effective date.—Under the House bill, this provision was to be applicable with respect to sales or other dispositions occurring after May 27, 1969. The committee amendments provide that the provision is to be applicable with respect to sales or other dispositions occurring after October 9, 1969, except where the sale or disposition is made pursuant to a binding contract entered into on or before that date.

3. Original Issue Discount (sec. 413 of the bill and sec. 1232 of the code)

Present law.—Present law provides that original issue discount arises where a corporation issues a bond (debenture, note, certificate, or other evidence of indebtedness) for a price less than the face amount of the bond, if the bond is a capital asset in the hands of the person acquiring it. The amount of the original issue discount is the difference between the face value of the bond (its stated redemption value) and the issue price. The owner of the bond is not taxed on the original issue discount until the bond is redeemed, if he holds it until maturity, or until he sells or otherwise disposes of the bond in a taxable transaction. In the latter case, only that portion of the gain realized by the owner of the bond on its sale which is equal to the part of the original issue discount attributable to the period he has held the bond is taxed at ordinary income rates. The remainder of the gain is treated as capital gain.

The issuing corporation, on the other hand, amortizes the amount of the original issue discount over the life of the bond. In other words, it is allowed a current interest deduction with regard to the original issue discount.

General reasons for change.—The present treatment of original issue discount results in a nonparallel treatment of the corporation issuing the bond and the person acquiring the bond. The corporation is allowed a deduction each year with respect to the discount. On the other hand, the holder is not required to report any income with respect to the original issue discount until he disposes of the bond. While it is quite likely that the discount always will be deducted by the corporation, it is probable that much of the ordinary income is not being reported by the owner of the bonds. Not only is the fact that this discount is taxable at the time of disposition likely to be forgotten, but also the fact that it is ordinary income rather than capital gain is likely to be overlooked.

This treatment of original issue discount may be another reason why a corporation might wish to use bonds to acquire another corporation. Thus, this aspect of the tax laws may require amendment not only because of the problems discussed above but also because it may provide an unwarranted inducement to merger activity.

The committee agrees with the House that there is not a sound basis for treating the corporation issuing the bonds and the owners of the bonds in a different manner with respect to the original issue discount on the bond. This is especially true in view of the fact that the present rules may have the effect of the original issue discount never being taxed to the owner of the bond.

Explanation of provision.—In general, the House bill and the committee amendments provide that the bondholder and the corporation issuing the bond are to be treated in a consistent manner with respect to the original issue discount on the bond. Under the bill, the bondholder is to be required to include the original issue discount in his income on a ratable basis over the life of the bond. As he includes the original issue discount in income, his basis for the bond would be correspondingly increased.

If a bondholder sells the bond prior to maturity (or it is redeemed), he would be treated as receiving capital gain based on his adjusted basis for the bond (taking into account the previous adjustments for the amount of original issue discount he had included in income), unless when the bond was originally issued there was an intention to call it before its maturity. In this case, under the House bill the gain on the sale (or redemption) of the bond would be treated as ordinary income to the extent of the full amount of original issue discount.

The committee amendments make a technical amendment to this provision of the House bill to insure that the amount of the gain treated as ordinary income does not include any amount of the original issue discount previously taxed to the bondholder or a prior bondholder.

The purchaser of the bond would be treated as standing in the place of the first owner so that the balance of the original issue discount, which had not been included in gross income by the first owner, would be included in income by the second owner ratably over the remaining life of the bond. Where the second owner purchases a bond for an amount above the first owner's adjusted basis for the bond, the second owner would be allowed to deduct this excess ratably over the remaining life of the bond from the original issue discount he otherwise would be required to include in income.

The ratable inclusion of original issue discount in income is not to be required of persons who purchased a bond at a premium.

The committee amendments also exclude life insurance companies from the scope of the ratable inclusion requirement to be imposed on bondholders. Under present law, life insurance companies must accrue original issue discount yearly either under a ratable method, such as provided by the bill, or under a method the company regularly employs, if the method is reasonable. A number of life insurance companies presently use the scientific (present value) method which is considered a reasonable method although it differs slightly from the ratable method. The committee amendments eliminate the necessity for a life insurance company shifting from this method of accruing discount which it has regularly employed to the ratable method of accruing discount. Since these methods produce essentially similar results, the committee believes this treatment is appropriate.

To facilitate the proper reporting of original issue discount and to facilitate the Internal Revenue Service's administration of this provision, a corporation issuing a bond in registered form would be required to furnish the owner of the bond and the Government with an annual information return (form 1099) with respect to the ratable amount of original issue discount to be included in the bondholder's income for the year.

In order to clarify the situations in which original issue discount may arise, the bill further provides that there may be original issue discount when a corporation issues a bond for a price less than its face value whether it receives cash, stock, or other property (including the assets of another corporation) for the bond. In the case where a bond is issued for property, it is provided that the issue price of the bond is to be the fair market value of the property.

To provide certainty of tax treatment, where a buyer and seller dealing at arms length have established a price for the property for which the bonds are issued, this price will be presumed to be the fair market value of the property.

In determining whether there is original issue discount, in the case where bonds are issued with warrants, the bill provides that the issue price of each element of the investment unit must be allocated between the elements of the investment unit on the basis of their respective fair market values.

The rules provided by the bill regarding the treatment of original issue discount are not to apply in the case of bonds or other evidences of indebtedness issued by any government or political subdivision (or in the case of bonds or other evidences of indebtedness issued by a corporation on or before October 9, 1969). In these cases, the rules of present law regarding the treatment of original issue discount on the sale or exchange of a bond which is a capital asset in the hands of the taxpayer and which has been held by the taxpayer for more than 6 months are to continue to apply. In addition, in these cases, gain on the sale or exchange of a bond or other evidence of indebtedness which is a capital asset in the hands of the taxpayer but which has not been held by the taxpayer for more than 6 months is to be treated as a short-term capital gain as under present law.

Effective date.—Under the House bill, this provision was to apply to bonds and other evidences of indebtedness issued after May 27, 1969. The committee amendments provide that the provision is to apply to bonds and other evidences of indebtedness issued after October 9, 1969, except where the indebtedness is issued pursuant to a binding commitment entered into prior to October 10, 1969.

4. Convertible Indebtedness Repurchase Premiums (sec. 414 of the bill and sec. 249 of the code)

Present law.—Under present law, there is a question as to whether a corporation which repurchases its convertible indebtedness at a premium may deduct the entire difference between the stated redemption price at maturity and the actual repurchase price. The Internal Revenue Service takes the position that the deduction is limited to an amount which represents a true interest expense (i.e., the cost of borrowing) and does not include the amount of the premium attributable to the conversion feature. This part of the repurchase is viewed by the Revenue Service as a capital transaction analogous to a corporation's repurchase of its own stock for which no deduction is allowable. There are, however, court cases which hold to the contrary and allow the deduction of the entire premium. In addition, other court cases have been filed by taxpayers to test the validity of the Service's position on this matter.

General reasons for change.—The committee agrees with the House that the treatment of premiums paid by a corporation on the repurchase of its convertible indebtedness should be clarified. It appears to the committee, as it did to the House, that the amount of the premium which is in excess of the cost of borrowing is not analogous to an interest expense or deductible business expense, but rather is similar to an amount paid in a capital transaction. In effect, the corporation is repurchasing the right to convert the bonds into its common stock, much as it might purchase its stock.

Explanation of provision.—In order to clarify the treatment of premiums paid on the repurchase by a corporation of its indebtedness which is convertible into its own stock (or the stock of a controlling or controlled corporation), the House bill and the committee amendments provide that the amount of the premium which may be deducted is to be limited to an amount not in excess of a normal call premium for nonconvertible corporate indebtedness. The amount of the premium paid by the corporation upon the repurchase is to be the excess of the amount paid over the issue price of the indebtedness (plus any amount of discount previously deducted and minus any amount of premium previously reported as income).

It is further provided by the bill that a larger deduction may be allowed with respect to the premium where the corporation can demonstrate to the satisfaction of the Secretary or his delegate that the amount of the premium in excess of that otherwise allowed as a deduction is related to the cost of borrowing and is not attributable to the conversion feature of the indebtedness. This exception is designed to allow for changes in the interest rates and to permit market and credit conditions to be taken into account.

Effective date.—This provision was to apply under the House bill with respect to repurchases of convertible indebtedness after April 22, 1969, unless the repurchase was pursuant to a binding obligation incurred on or before that date to repurchase at a specified call premium.

Under the committee amendments this provision is to apply with respect to repurchases of convertible indebtedness after October 9, 1969, except where the repurchase is pursuant to a binding obligation incurred on or before that date to repurchase at a specified call premium. The bill provides that in such a case no inference is to be drawn as to the deductibility of that portion of the premium which is attributable to the conversion feature from the fact that this provision of the bill does not apply to that convertible indebtedness. The committee further intends that no inference is to be drawn as to the proper treatment under present law of a premium paid by a corporation on the repurchase of its convertible indebtedness either from the enactment of this provision or from the fact that this provision does not apply to repurchases of indebtedness prior to October 10, 1969.

L. STOCK DIVIDENDS

(Sec. 421 of the bill and secs. 301 and 305 of the code)

Present law.—In its simplest form, a stock dividend is commonly thought of as a mere readjustment of the stockholder's interest, and not as income. For example, if a corporation with only common stock outstanding issues more common stock as a dividend, no basic change is made in the position of the corporation and its stockholders. No corporate assets are paid out, and the distribution merely gives each stockholder more pieces of paper to represent the same interest in the corporation.

On the other hand, stock dividends may also be used in a way that alters the interests of the stockholders. For example, if a corporation with only common stock outstanding declares a dividend payable at the election of each stockholder, either in additional common stock or in cash, the stockholder who receives a stock dividend is in the same position as if he received a taxable cash dividend and purchased additional stock with the proceeds. His interest in the corporation is increased relative to the interests of stockholders who took dividends in cash.

Present law (sec. 305(a)) provides that if a corporation pays a dividend to its shareholders in its own stock (or in rights to acquire its stock), the shareholders are not required to include the value of the dividend in income. There are two exceptions to this general rule. First, stock dividends paid in discharge of preference dividends for the current or immediately preceding taxable year are taxable. Second, a stock dividend is taxable if any shareholder may elect to receive his dividend in cash or other property instead of stock.

These provisions were enacted as part of the Internal Revenue Code of 1954. Before 1954 the taxability of stock dividends was determined under the "proportionate interest test," which developed out of a series of Supreme Court cases, beginning with *Eisner* v. *Macomber*, 252 U.S. 189 (1920). In these cases the Court held, in general, that a stock dividend was taxable if it increased any shareholder's proportionate interest in the corporation. The lower courts often had difficulty in applying the test as formulated in these cases, particularly where unusual corporate capital structures were involved.

Soon after the proportionate interest test was eliminated in the 1954 Code, corporations began to develop methods by which shareholders could, in effect, be given a choice between receiving cash dividends or increasing their proportionate interests in the corporation in much the same way as if they had received cash dividends and reinvested them in the corporation. The earliest of these methods involves dividing the common stock of the corporation into two classes, A and B. The two classes share equally in earnings and profits and in assets on liquidation. The only difference is that the class A stock pays only stock dividends and class B stock pays only cash dividends. The market value of the stock dividends paid on the class A stock is equated annually to the cash dividends paid on the class B stock. Class A stock may be converted into class B stock at any time. The stockholders can choose, either when the classes are established, when they purchase new stock, or through the convertibility option whether to own class A stock or class B stock.

In 1956, the Treasury Department issued proposed regulations which treated such arrangements as taxable (under sec. 305(b)(2)) as distributions subject to an election by the stockholder to receive cash instead of stock. In recent years, however, increasingly complex and sophisticated variations of this basic arrangement have been created. In some of these arrangements, the proportionate interest of one class of shareholders is increased even though no actual distribution of stock is made. This effect may be achieved, for example, by paying cash dividends on common stock and increasing by a corresponding amount the ratio at which convertible preferred stock or convertible debentures may be converted into common stock. Another method of achieving this result is a systematic periodic redemption plan, under which a small percentage, such as 5 percent, of each shareholder's stock may be redeemed annually at his election. Shareholders who do not choose to have their stock redeemed automatically increase their proportionate interest in the corporation.

On January 10, 1969, the Internal Revenue Service issued final regulations (T.D. 6990) under which a number of methods of achieving the effect of a cash dividend to some shareholders and a corresponding increase in the proportionate interest of other shareholders are brought under the exceptions in section 305(b), with the result that shareholders who receive increases in proportionate interest are treated as receiving taxable distributions.

General reasons for change.—The final regulations issued on January 10, 1969, do not cover all of the arrangements by which cash dividends can be paid to some shareholders and other shareholders can be given corresponding increases in proportionate interest. For example, the periodic redemption plan described above is not covered by the regulations, and the committee believes it is not covered by the present statutory language (of sec. 305(b)(2)).

Methods have also been devised to give preferred stockholders the equivalent of dividends on preferred stock which are not taxable as such under present law. For example, a corporation may issue preferred stock for $100 per share which pays no dividends, but which may be redeemed in 20 years for $200. The effect is the same as if the corporation distributed preferred stock equal to 5 percent of the original stock each year during the 20-year period in lieu of cash dividends. The committee believes that dividends paid on preferred stock should be taxed whether they are received in cash on in another form, such as stock, rights to receive stock, or rights to receive an increased amount on redemption. Moreover, the committee believes that dividends on preferred stock should be taxed to the recipients whether they are attributable to the current or immediately preceding taxable year or to earlier taxable years.

Explanation of provisions.—The bill continues (in sec. 305(b)(1)) the provision of present law that a stock dividend is taxable if it is payable at the election of any shareholder in property instead of stock.

The bill provides (in sec. 305(b)(2)) that if there is a distribution or series of distributions of stock which has the result of the receipt of cash or other property by some shareholders and an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation, the shareholders receiving stock are to be taxable (under sec. 301).

For example, if a corporation has two classes of common stock, one paying regular cash dividends and the other paying corresponding stock dividends (whether in common or preferred stock), the stock dividends are to be taxable.

On the other hand, if a corporation has a single class of common stock and a class of preferred stock which pays cash dividends and is not convertible, and it distributes a pro rata common stock dividend with respect to its common stock, the stock distribution is not taxable because the distribution does not have the result of increasing the proportionate interests of any of the stockholders.

In determining whether there is a disproportionate distribution, any security convertible into stock or any right to acquire stock is to be treated as outstanding stock. For example, if a corporation has common stock and convertible debentures outstanding, and it pays interest on the convertible debentures and stock dividends on the common stock, there is a disproportionate distribution, and the stock dividends are to be taxable (under section 301). In addition, in determining whether there is a disproportionate distribution with respect to a shareholder, each class of stock is to be considered separately.

The committee has added two provisions to the House bill (secs. 305(b) (3) and (4)) which carry out more explicitly the intention of the House with regard to distibutions of common and preferred stock on common stock, and stock distributions on preferred stock. The first of these provides that if a distribution or series of distributions has the result of the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders, all of the shareholders are taxable (under sec. 301) on the receipt of the stock.

The second of the provisions added by the committee (sec. 305(b)(4) provides that distributions of stock with respect to preferred stock are taxable (under sec. 301). This provision applies to all distributions on preferred stock except increases in the conversion ratio of convertible preferred stock made solely to take account of stock dividends or stock splits with respect to the stock into which the convertible stock is convertible.

The bill provides (in section 305(b)(5)) that a distribution of convertible preferred stock is taxable (under sec. 301) unless it is established to the satisfaction of the Secretary or his delegate that it will not have the result of a disproportionate distribution described above. For example, if a corporation makes a pro rata distribution on its common stock of preferred stock convertible into common stock at a price slightly higher than the market price of the common stock on the date of distribution, and the period during which the stock must be converted is 4 months, it is likely that a distribution would have the result of a disproportionate distribution. Those stockholders who wish to increase their interests in the corporation would convert their stock into common stock at the end of the 4-month period, and those stockholders who wish to receive cash would sell their stock or have it redeemed. On the other hand, if the stock were convertible for a period of 20 years from the date of issuance, there would be a likelihood that substantially all of the stock would be converted into common stock, and there would be no change in the proportionate interest of the common shareholders.

The bill provides (in sec. 305(c)) that under regulations prescribed by the Secretary or his delegate, a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption treated as a section 301 distribution, or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder is to be treated as a distribution with respect to each shareholder whose proportionate interest is thereby increased. The purpose of this provision is to give the Secretary authority to deal with transactions that have the effect of distributions, but in which stock is not actually distributed.

The proportionate interest of a shareholder can be increased not only by the payment of a stock dividend not paid to other shareholders, but by such methods as increasing the ratio at which his stock, convertible securities, or rights to stock may be converted into other stock, by decreasing the ratio at which other stock, convertible securities, or rights to stock can be converted into stock of the class he owns, or by the periodic redemption of stock owned by other shareholders. It is not clear under present law to what extent increases of this kind would be considered distributions of stock or rights to stock. In order to eliminate uncertainty, the committee has authorized the Secretary or his delegate to prescribe regulations governing the extent to which such transactions shall be treated as taxable distributions.

For example, if a corporation has a single class of common stock which pays no dividends and a class of preferred stock which pays regular cash dividends, and which is convertible into the common stock at a conversion ratio that decreases each year to adjust for the payment of the cash dividends on the preferred stock, it is anticipated that the regulations will provide in appropriate circumstances that the holders of the common stock will be treated as receiving stock in a disproportionate distribution (under sec. 305(b)(2)).

It is anticipated that the regulations will establish rules for determining when and to what extent the automatic increase in proportionate interest accruing to stockholders as a result of redemptions under a periodic redemption plan are to be treated as taxable distributions. A periodic redemption plan may exist, for example, where a corporation agrees to redeem a small percentage of each common shareholder's stock annually at the election of the shareholder. The shareholders whose stock is redeemed receive cash, and the shareholders whose stock is not redeemed receive an automatic increase in their proportionate interests. However, the committee does not intend that this regulatory authority is to be used to bring isolated redemptions of stock under the disproportionate distribution rule (of sec. 305(b)(2)). For example, a 30 percent stockholder would not be treated as receiving a constructive dividend because a 70 percent stockholder causes a corporation to redeem 15 percent of its stock from him.

The provision giving the Secretary authority to treat certain transactions as distributions (sec. 305(c)) also applies to distributions on preferred stock. For example, assume that a corporation issues preferred stock convertible into its common stock, and that the preferred stock pays no cash dividends, but the ratio at which it may be converted into common stock increases annually by a specified percentage. It is anticipated that the regulations will provide that the change in conversion ratio in such a case constitutes a taxable distribution of a right to acquire stock. Similarly, a corporation may issue preferred stock which pays no cash dividends, but which may be redeemed after a specified period of time at a price higher than the issue price. It is anticipated that, unless the increase is a reasonable call premium, it will be treated under the regulations as constructively received by the stockholder over the period during which the preferred stock cannot be called for redemption.

It is anticipated that the regulations will provide that if preferred stockholders are given stock in a recapitalization, or an increase in proportionate interest by means of a constructive distribution, as payment of current dividends or dividend arrearages, sec. 305(b)(4) is to apply whether or not the recapitalization or other transaction is an isolated transaction. Thus, if in a recapitalization preferred stockholders are given additional preferred stock in satisfaction of several years dividend arrearages, the distribution of the additional stock will be taxable (under sec. 301).

The committee amendments provide a *de minimis* rule with respect to disproportionate distributions. The disproportionate distribution rule is not to apply to a stock dividend paid (or deemed paid) to a class of shareholders if the distribution, together with all prior distributions to that class of shareholders during the 36 month period ending on the date of the distribution, did not have the effect of increasing the proportionate interest of that class of shareholders in the assets or earnings or profits of the corporation by more than $\frac{1}{10}$ of 1 percent. This test is applied on a distribution by distribution basis, taking into account any distributions in the prior 36 months (including distributions before the effective date of this act).

This provision (sec. 305) is not intended to affect the characterization of a nonprorata distribution (or deemed distribution) as a gift, compensation, adjustment of purchase price, and so forth. For example, a nonprorata distribution on common stock may have the effect of a gift to the recipient by the other stockholders.

Effective date.—This amendment is to apply to distributions (or deemed distributions) made or considered as made after January 10, 1969, in taxable years ending after that date.

The amendment is not to apply to a distribution (or deemed distribution) made before January 1, 1991, with respect to stock outstanding on January 10, 1969, or issued pursuant to a contract binding on January 10, 1969, on the distributing corporation. A contract is considered binding on the distributing corporation on January 10, 1969, if it is binding on the management of the distributing corporation on that date, even though necessary stockholder approval is obtained later.

The committee understands that the September 7, 1968, date in the transitional rule of the regulations will be changed to January 10, 1969, so that there will not be a gap between the transitional rule of the regulations and the transitional rule of the bill.

The transitional rule, as contained in the House bill, was intended to apply only where the corporation's dividend policy and capital structure on January 10, 1969, were such that stock dividends paid by it would be taxable under the bill. To prevent avoidance of the House provision, the committee amendments provide that the transitional rule does not apply unless the stock as to which there is a receipt of property was also outstanding on January 10, 1969 (or was issued pursuant to a contract binding on that date). If the stock was also outstanding on January 10, 1968, the transitional rule applies only if the corporation made, on or before January 10, 1969, a distribution of property with respect to the stock, and a distribution (or deemed distribution) of stock with respect to the stock to which the transitional rule applies.

Under the House bill, shareholders of corporations to which the transitional rule applies would be taxable on stock dividends paid on stock issued after January 10, 1969, even if the new stock was issued as a dividend on stock to which the transitional rule applies. Under the committee amendments, the transitional rule also applies to additional stock, whether sold or distributed as stock dividends, if the new stock is of the class of stock having the largest fair market value of all the classes of stock subject to the transitional rule. (This would normally be common stock of the corporation.) It also applies to stock received as dividends on stock to which the transitional rule applies.

Under the committee amendments, the transitional rule ceases to apply if at any time after October 9, 1969, the corporation issues any stock (other than in a distribution with respect to stock of the same class) which is not—

(a) nonconvertible preferred stock;

(b) additional stock of the class of stock having the largest fair market value of the classes of stock subject to the transitional rule;

(c) preferred stock convertible into the class of stock referred to in (b), if it has full antidilution protection.

The committee amendments also provide a transitional rule under which increases in the conversion ratio of convertible stock made before January 1, 1991, will not be taxable if they are made pursuant to the terms relating to its issuance which were in effect on January 10, 1969.

In cases to which Treasury Decision 6990 would not have applied, April 22, 1969, is substituted for January 10, 1969, for purposes of the effective date and the transitional rule.

Revenue effect.—The amendment will not have any immediate revenue impact. However, if the law were to permit the tax-free distribution of stock dividends on part of the common stock while cash is distributed on the remaining common stock, the revenue loss would be very substantial because it is probable that many publicly held corporations would adopt a capital structure with two classes of common stock so that their stock could be sold both to investors desiring appreciation and to investors desiring a current income. The amendment makes all transactions having this effect taxable and thus makes it certain that a substantial revenue loss will not occur.

M. FINANCIAL INSTITUTIONS

1. Commercial Banks—Reserve for Losses on Loans (sec. 431 of the bill and sec. 585 of the code)

Present law.—Commercial banks are permitted, by administrative rulings, more generous bad-debt reserves than most taxpayers. To protect banks against possible catastrophic losses, the Treasury Department in 1947 permitted a bank to accumulate a reserve not exceeding three times the moving average of its annual percentage loss during the last 20 years. This was changed in 1954 to allow banks to determine their average loss experience on the basis of any 20 consecutive years after 1927. In 1965, Revenue Ruling 65-92 (C.B. 1965-1, 112) granted commercial banks on an industrywide basis the privilege of building up a bad-debt reserve equal to 2.4 percent of outstanding loans not insured by the Federal Government. The 2.4-percent figure used for this purpose is roughly three times the annual bad-debt loss of commercial banks during the period 1928-47. This is the present treatment except that in 1968, Revenue Ruling 68-630 (C.B. 1968-2, 84) clarified the loan base used for computing the allowable bad-debt reserve to include only those loans on which banks can suffer an economic loss.

General reasons for change.—By allowing commercial banks to build up bad-debt reserves equal to 2.4 percent of uninsured outstanding loans, present law gives them much more favorable treatment than most other taxpayers. Section 166(c) of the Internal Revenue Code permits business taxpayers to take a deduction for a reasonable addition to a reserve for bad debts. Most taxpayers accumulate a bad-debt reserve equal to the ratio of the average year's losses to accounts receivable. The average loss is computed on the basis of losses for the current year and the 5 preceding years.

Commercial banks have the option of establishing their bad-debt reserves on the basis of their actual experience like other taxpayers. However, they generally elect to build up these reserve on the basis of the industrywide 2.4-percent figure permitted by Revenue Ruling 65-92. If banks were building up their bad-debt reserves on the basis of their own experience in the last six years, they would on the average be allowed to build up a bad-debt reserve of about 0.2 percent of outstanding noninsured loans.

Explanation of provisions.—The committee's bill provides that in the future commercial banks will be permitted to build up bad debt reserves equal to only 1.8 percent of outstanding eligible loans instead of 2.4 percent of such loans as at present. However, a transition rule is provided for banks which at the close of the last taxable year beginning before July 11, 1969, had bad debt reserves in excess of the 1.8 percent figure. These banks will not be required to reduce their reserves; nor, however, will they be entitled to increase their reserve except to maintain current levels, or until additions are needed to bring reserves up to the 1.8 percent level. Accordingly, so long as banks have reserves in excess of 1.8 percent of outstanding eligible loans, they will be allowed to deduct only actual losses. In the long run, however, banks with excess reserves will be brought down to the 1.8 percent level, as the volume of their outstanding loans increases over the years. The treatment for handling reserves where banks are over the allowable amounts, is the same as the procedure used in the House bill.

For purposes of the 1.8 percent bad debt reserve permitted by the committee provision, commercial banks are to use the same loan base as they use for the present 2.4 percent reserve (set forth under Revenue Ruling 68–630 (C.B. 1968–2, 84)). Accordingly, for purposes of building up their bad debt reserves, banks are not to be permitted to apply the 1.8 percent figure to such items as bank funds on deposit in another bank, the portion of loans offset by cash collateral, government-insured loans, investments in debt securities, and money market investments.

The treatment accorded by the committee's action to the bad debt reserves of banks differs considerably from the House bill. Under the House provision, in the future banks would generally have been per mitted to add to their bad debt reserves only the amount called for on the basis of their own experience as indicated by losses for the current year and the five preceding years. While the committee agrees with the general objective of curtailing the tax advantages that banks enjoy in regard to bad debt reserves, it believed it was undesirable to require banks to make this large a change. The committee believes that its provision to allow commercial banks to build up their bad debt reserves to 1.8 percent of eligible outstanding loans strikes a better balance between the need to prevent banks from securing undue tax advantages from their bad debt reserves and the need for banks, as custodians of their depositors' funds, to keep bad debt reserves at levels adequate to meet emergencies.

As a practical matter, in the short run, the committee's provision and the House provision will have similar effects on most existing commercial banks. Most established banks have built up bad debt reserves in excess of the 1.8 percent level permitted by the committee's bill. Accordingly, under the committee amendments, these banks will be allowed to deduct only actual bad debts losses until such time as their loan base expands enough to bring them below the 1.8 percent level. During this period of time, they will be treated in the same way as under the House provision.

Nevertheless, the committee's provision will have a substantially different impact on new banks and on others with reserves below 1.8 percent than would the House provision. The committee provision will permit new banks (and the others with relatively low reserves) to build up their reserves to the 1.8 percent level. In contrast the House bill would put such new banks immediately on an experience basis with an option in the first ten years of their existence to establish their bad debt reserves on the basis of the industry-wide average for the six preceding taxable years. The committee believes that the House treatment would place new banks at a competitive disadvantage for many years since it would not give them the opportunity to build up their bad debt reserves, while existing banks would not have to reduce the dollar amount of the reserves they already had built up before the legislation. By allowing new banks to build their bad debt reserves to the 1.8 percent level, the committee's bill largely eliminates this competitive problem. Moreover, this action makes it unnecessary to give new banks the option provided by the House bill of taking bad debt deductions during the first ten years of their existence on the basis of the industry-wide average. Accordingly, the committee's bill eliminates this option.

The committee's bill does not include the House provision to permit banks to carry back net operating losses for ten years instead of three years as under present law. The House provided for this more liberal carryback of net operating losses for banks because it believed that such treatment was needed to avoid possible hardship in view of the fact that the bad debt reserves of banks were to be brought down drastically to the experience level. Such an expansion in the carryback period, however, is no longer needed under the committee's provision which allows commercial banks to build up their bad debt reserves to 1.8 percent of outstanding eligible loans.

Effective date.—The committee's provision is to apply with respect to taxable years beginning after July 11, 1969. This is the same effective date as in the House bill.

Revenue effect.—The revenue increases resulting from this provision are estimated at $225 million in 1970, $150 million in 1971, and $100 million in each of the years from 1973 through 1979. The revenue increases are large in the initial years after the effective date than in later years because in the initial years many existing banks will have bad debt reserves in excess of the 1.8 percent specified level so that they will have to take bad debt deductions based on actual experience. In the later years, such banks will be permitted to take deductions under the 1.8 percent approach because expansion in the eligible loan base will eventually bring bad debt reserves below this level.

2. Small Business Investment Companies, Etc.—Reserve for Losses on Loans (sec. 431 of the bill and sec. 586 of the code)

Present law.—In the past, small business investment companies have been allowed to build up a bad-debt reserve amounting to 10 percent of their outstanding loans. This was a temporary revenue ruling designed to provide a basis for computing the reserve in the absence of experience or experience of any comparable industry. Presently, however, small business investment companies and also business development corporations must base additions to their bad-debt reserves on their own experience in the current year and the 5 preceding years.

General reasons for change.—Requiring a small business investment company or a business development corporation to base its bad-debt deductions upon its own experience has created problems for new companies. Such companies, although they may subsequently realize losses, initially are unlikely to have much if any losses.

Explanation of provisions.—The committee amendments provide that a new small business investment company or a new business development corporation may during the first 10 years of its existence base its bad-debt reserves upon the industry average. After the first 10 years of its existence, a small business investment company or a business development corporation must then base additions to its bad-debt reserves, as under present law, on its own experience. This adopts identical provisions of the House bill with respect to these two types of organizations.

Effective Date.—This provision under both the House bill and the committee amendments is to apply to taxable years beginning after July 11, 1969.

Revenue Effect.—The revenue effect of this provision is expected to be small.

3. Mutual Savings Banks, Savings and Loan Associations, Etc. (secs. 432 and 434 of the bill and secs. 593, 596, and 7701(a) of the code)

Present law.—Under present law businesses generally are entitled to use the reserve method of accounting for bad-debt losses, but in computing this reserve are allowed a tax deduction for an addition to a reserve for bad debts only to the extent it is justified by their actual loss experience.

Mutual savings banks, savings and loan associations, and cooperative banks (referred to below as "mutual institutions" although including some stock companies), however, may compute additions to their bad-debt reserves on the basis of their actual experience or under one of two alternative formulas (specified by the 1962 Revenue Act), whichever produces the greatest addition to the reserve. The two alternative formulas essentially provide for the deduction of (1) 60 percent of taxable income, or (2) 3 percent of qualifying real property loans. As pointed out above, the taxpayer can, of course, deduct the amount dictated by the actual experience of the company, if this results in a larger deduction.

Under the 60-percent method, a mutual institution is permitted to deduct each year an amount equal to 60 percent of its taxable income (computed before any bad-debt deduction). However, this deduction may not bring the balance of the bad-debt reserve (at the close of the year) to more than 6 percent of qualifying real property loans.

Under the 3-percent method, an institution is permitted to deduct an amount sufficient to bring the balance of the reserve for losses on qualifying real property loans to 3 percent of such loans outstanding at the close of the taxable year, plus an amount sufficient to bring the balance of the reserve for losses on other loans to a "reasonable" amount. In the case of new institutions, the percentage is increased to 5 percent within specified limits. In general, the term "qualifying real property loan" means any loan secured by an interest in improved real property or by an interest in real property which is to be improved out of the proceeds of the loan, subject to certain limitations.

A savings and loan association and a cooperative bank are entitled to use the 3-percent or 60-percent method only if they meet a comprehensive set of investment standards. These standards were established by Congress in the 1962 act to insure that the tax benefits are available only to those institutions primarily engaged in the business of home mortgage financing. In general, these standards require that 82 percent of the institution's assets must be invested in residential real estate, liquid reserves, and certain other assets. Mutual savings banks are not subject to any investment standards under these tax provisions and may use the special reserve methods regardless of the amount of their investments in home mortgage financing.

General reasons for change.—Until 1952 mutual savings banks, domestic building and loan associations, and certain cooperative banks were exempt from Federal income tax. Allowance of the exemption was based upon the premise that money belonging to members of these institutions was being used for loans to members—that is, the members were, in effect, doing business with themselves—and that since the earnings of the institutions belonged to the depositors there could be no profit of the institution on which to impose an income tax.

In 1952 Congress repealed the exemption of these institutions and subjected them to the regular corporate income tax. In part, at least, this change was based on the fact that these institutions no longer dealt only with members but made most of their loans to nonmembers. At that time, however, these institutions were allowed a special deduction for additions to bad debt reserves which proved to be so large that they remained virtually tax exempt.

In the Revenue Act of 1962, Congress sought to end this virtual tax exemption but in so doing nevertheless decided that these institutions should still retain quite favorable treatment for their bad-debt reserves, since much of their loans were for residential real estate, and Congress believed that incentives for such loans were in the interest of the economy. Accordingly, the 1962 act provided special alternative methods for these institutions in the computation of their bad-debt reserves, which, although more liberal than that accorded other financial institutions, nevertheless were more restrictive than prior law.

It was expected that most of these institutions would compute their deduction under the 60-percent method, which requires the payment of some tax, while the 3-percent method would be an alternative primarily benefiting a limited number of new or rapidly growing institutions. In practice, about 90 percent of the savings and loan associations use the 60-percent method and are currently paying taxes in the manner generally anticipated under the tax formula adopted in 1962. However, most mutual savings banks use the 3-percent method and have continued to avoid substantially all Federal income taxes. The table presented below shows the tax payments, economic income, and taxes as a percent of this income for commercial banks, mutual savings banks, and savings and loan associations for the most recent available years. As indicated in this table, taxes as a percent of economic income are much lower for mutual savings banks than for commercial banks or savings and loan associations.

TABLE 13.—INCOME TAX REPORTED IN "STATISTICS OF INCOME" AS A PERCENT OF INCOME SUBJECT TO TAX AND AS A PERCENT OF ECONOMIC INCOME OF COMMERCIAL BANKS, MUTUAL SAVINGS BANKS, AND SAVINGS AND LOAN ASSOCIATIONS, 1955–67

[Dollar amounts in millions]

	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967
I. Income subject to tax (SOI):													
A. Commerical banks	(1)	(1)	(1)	(1)	$1,696	$2,914	$2,855	$2,531	$2,366	$2,292	$2,204	$2,092	$2,479
B. Mutual savings banks	(1)	(1)	(1)	(1)	$3	$3	$5	$7	$10	$15	$24	$22	$14
C. Savings and loan associations	(1)	(1)	(1)	(1)	$16	$15	$15	$20	$264	$298	$317	$251	$236
II. Federal income tax (SOI):[2]													
A. Commerical banks	$721.6	$763.3	$988.4	$1,215.5	$807.8	$1,362.6	$1,291.7	$1,168.7	$1,078.8	$999.8	$879.9	$845.2	$977.8
B. Mutual savings banks	$1.9	$1.2	$.8	$1.5	$.9	$.8	$1.5	$1.5	$3.4	$5.2	$8.2	$7.2	$4.3
C. Savings and loan associations	$5.6	$6.7	$5.9	$7.3	$6.2	$5.6	$5.8	$7.2	$115.6	$122.2	$126.0	$98.1	$90.1
III. Tax as a percent of income subject to tax:													
A. Commercial banks	(1)	(1)	(1)	(1)	47.6	46.8	45.2	46.2	45.6	43.6	39.9	40.4	39.4
B. Mutual savings banks	(1)	(1)	(1)	(1)	33.2	31.3	29.9	21.9	32.9	34.8	33.9	33.0	31.3
C. Savings and loan associations	(1)	(1)	(1)	(1)	38.5	37.7	38.6	35.5	43.8	41.1	39.8	39.1	38.1
IV. Economic income:[3]													
A. Commercial banks	$2,109	$2,257	$2,578	$3,379	$2,360	$3,801	$3,626	$3,513	$3,523	$3,546	$3,783	$3,643	(1)
B. Mutual savings banks	$132	$139	$133	$182	$159	$115	$237	$139	$158	$190	$249	$118	(1)
C. Savings and loan associations	$346	$391	$398	$444	$539	$539	$704	$811	$723	$824	$830	$579	(1)
V. Tax as a percent of economic income:													
A. Commercial banks	34.2	33.8	38.3	36.0	34.2	37.8	35.6	33.3	30.6	38.2	23.3	23.2	(1)
B. Mutual savings banks	1.4	.9	.6	.8	.6	.7	.6	1.1	2.2	2.7	3.3	6.1	(1)
C. Savings and loan associations	1.6	1.7	1.5	1.6	1.2	1.0	.8	.9	16.0	14.8	15.2	16.9	(1)

[1] Not available.
[2] Figures for 1962–67 are after tax credits; for prior years, tax is gross before tax credits.
[3] Economic income includes receipts from all sources less deductions as shown in SOI adjusted by adding the bad debt deduction in SOI and subtracting actual losses.

Sources: Internal Revenue Service Statistics of Income, Source Book; Federal Deposit Insurance Corporation, annual report; 1967 information is preliminary and subject to revision.

The committee has reviewed the tax treatment of these mutual institutions. It agrees with the House that the present bad-debt reserve provisions are unduly generous as they have allowed these institutions to pay a much lower average effective rate of tax than the average effective rate for all corporations. Accordingly, the committee amendments modify the special bad-debt reserve provisions of existing law which are applicable to these institutions by repealing the 3-percent method and reducing the present 60-percent method to 50 percent over a 4-year period (the House bill would have reduced it to 30 percent over a 10-year period), providing what it believes will be an assurance that significant tax will be paid in most cases on the retained earnings of these institutions.

The committee believes that, notwithstanding the larger tax liability because of the changes in the bad-debt reserve deductions, there will still be reserves consistent with the proper protection of the institutions and its policyholders in the light of the peculiar risks of long-term lending on residental real estate which is the principal function of these institutions.

The committee also agrees with the House that the investment standards presently applicable to savings and loan associations should be expanded in a revised form to cover mutual savings banks as well. There is no reason for providing mutual savings banks and savings and loan associations a special tax benefit except for the fact that they are a major source of home mortgage loans, an activity which Congress has indicated it desires to encourage. In this regard, it is the desire of the committee to treat mutual savings banks and savings and loan associations largely on a comparable basis. However, in view of the traditional differences in loan portfolios of savings and loan associations and mutual savings banks, the level of required real estate loans and other qualifying loans is not to be as high for mutual savings banks.

The committee, however, is also concerned with a problem not dealt with in the House bill. Presently, mutual savings banks (but not savings and loan associations which are restricted under state and federal law) can invest heavily in corporate stocks, report only 15 percent of their dividend income for tax purposes (since they are allowed an 85 percent deduction for the corporate dividends they receive) and then offset the entire amounts as interest paid to depositors. This tends to nullify much of the incentive for investing in home mortgage loans.

Explanation of provision.—Both the House bill and the committee amendments revise the tax treatment of mutual savings banks, co-operative banks and savings and loan associations in a number of ways. Both amend the special bad-debt reserve provisions by eliminating the 3-percent method and reducing the present 60-percent method. The House bill would have reduced this 60 percent to 30 percent gradually over a 10-year period. The committee amendments reduce this to 50 percent over a 4-year period. The committee believes that the reduction to 50 percent represents a sufficient increase in taxes for these mutual institutions at this time. This means that, under the committee's bill, the deduction will be 57 percent for a taxable year beginning in 1970, 54 percent in 1971, 51 percent in 1972, and fixed at 50 percent for taxable years beginning in 1973 and thereafter. As under present law, the deduction computed under this method (minus the amount added to the reserve for losses on nonqualifying loans) may not exceed an amount necessary to increase the balance of the reserve for losses on qualifying real property loans to 6 percent of these loans.

The committee amendments also deal with the interrelationship of the 50-percent deduction with the intercorporate dividends received deduction in the case of mutual savings banks and savings and loan associations (the latter, however, under their Federal or State supervision are not permitted to have any appreciable investments in corporate stock). Under present law the income on which the 60-percent (50 percent under the committee amendments) deduction is computed includes net capital gain from the sale of stock and Government obligations and also dividend income qualifying for the intercorporate dividends received deduction. The House bill, however, excludes from the base on which the bad-debt deduction is computed net capital gain from the sale of corporate stock or Government obligations, three-eighths of the net long-term capital gain from the sale of other property (the extent of the preferential capital gains rate for corporations) and the dividend income qualifying for the intercorporate dividends received deduction. The committee amendments continue the same treatment for capital gains as provided by the House bill.

In the case of the intercorporate dividends received deduction, however, the committee amendments allocate the deduction between the portion of the income subject to tax and the portion which is allowed as a bad-debt reserve deduction. Thus, that portion of the dividend received deduction equal to the percentage of the bad debt deduction allowed under the special percentage method (50 percent for those institutions fully entitled to the deduction after the transitional period) will be disallowed. As under the House bill the income from corporate securities remaining after the dividends received deduction (the 15 percent remaining after deducting the 85 percent) is not to be taken into account in the base in determining the bad-debt deduction. This can be illustrated as follows: assume a mutual savings bank has $200,000 of interest income and $100,000 of dividend income. In this case $85,000 of the dividend income under present law would not be included in the savings bank tax base as a result of the dividend received deduction. However, as a result of the allocation, the allowable dividend received deduction is reduced by one-half, or to $42,500. Also, to prevent overlap with the bad-debt deduction, one-half of this $42,500 would be attributed to the bad-debt reserve in the case of an institution eligible to deduct 50 percent of its taxable income for this purpose. (As under the House bill, the $15,000, to which the intercorporate dividends received deduction did not apply, would not be taken into account in determining the 50-percent deduction.)

Thus, the 50-percent deduction would be computed on the basis of the $200,000 of interest income plus $42,500 of dividend income. The 50-percent bad-debt deduction in this case would be $121,250 leaving a like amount which, together with the $15,000 of security income remaining after the dividends received deduction indicates a tax base in this case of $136,250.

Under present law, a savings and loan association (and a cooperative bank) is entitled to use the special percentage deduction method for computing additions to bad debt reserves only if 82 percent of the institution's assets are invested in residential real estate, liquid reserves, and certain other assets. Since mutual savings banks are not subject to any investment standards, the committee agrees with the House that, inasmuch as the special percentage deduction method is provided because of these mutual institutions' investments in home mortgage financing, mutual savings banks also should be subject to such standards.

Both the House bill and the committee amendments revise the present investment standards applicable to savings and loan associations by liberalizing the composition of the qualifying assets, which are also to apply to mutual savings banks. The new investment standard is a flexible one which reduces the percentage (applied against taxable income, with certain adjustments, to compute the bad-debt reserve deduction) depending upon the percentage of investments in the qualifying assets—residential real property loans, liquid reserves, and certain other assets. The full percentage (50 percent at the end of a 4-year period under the committee amendments, or 30 percent at the end of a 10-year period under the House bill) is to be allowed generally only if the institution has a prescribed percentage—82 percent for savings and loan associations and cooperative banks and 72 percent for mutual savings banks—of its investments in qualifying assets. The percentage is reduced by 1 percent for every 1 percent that a savings and loan institution's qualifying assets are less than the prescribed percentage of total assets (or by 1.5 percentage points for every 1 percent in the case of mutual savings banks since they are only required to meet the 72-percent test on qualified assets). However, if less than 60 percent of the institution's funds are in qualifying assets (50 percent for mutual savings banks during the transition period), the percentage deduction method may not be used. Both versions of the bill also allow these institutions to compute their bad-debt reserves on the basis of the 6-year moving average of their own experience rather than on the basis of the percentage deduction method.

An example where the above stated percentage reductions would apply is as follows: if in 1975 (at which time the 4-year transitional period will have reduced the percentage for the special deduction method to 50 percent) either type of institution has only the minimum 60 percent of its funds in qualifying assets, the percentage deduction for a savings and loan association would be 28 percent (a 22-point reduction from 50 percent because it is 22 points below the 82-percent level for qualifying assets), and the percentage deduction for a mutual savings bank would be 32 percent (an 18-point reduction from 50 percent because it is 12 points below the 72-percent level for qualifying assets).

The committee amendments also modify somewhat the types of loans which are taken into account in determining whether a mutual institution qualifies under the 82- or 72-percent asset requirement which must be met for the 50-percent deduction to be available. Under the House bill the following investments were included in qualifying assets for this purpose:

(1) Loans for residential real property, including real property primarily used for church purposes, facilities in residential developments dedicated to public use (e.g., schools and libraries), and property used on a nonprofit basis by residents (e.g., swimming pools, etc.) and mobile homes not used on a transient basis.

(2) Loans for the improvement of commercial or residential property in an urban renewal area or in an area eligible for assistance under the Demonstration Cities and Metropolitan Development Act.

(3) Loans for educational, health and welfare institutions or facilities including facilities primarily for students, residents, etc.

(4) Property acquired through the liquidation of any of the prior three categories.

(5) Student loans.

(6) Property used by the mutual institution in its business.

The committee amendments have modified the above categories to include loans secured by an interest in real property located in an urban renewal area to be developed for predominantly residential use under an urban renewal plan or located in an area covered by a program under the Demonstration Cities and Metropolitan Development Act. Loans for residential purposes are also defined as including loans secured by redeemable ground rents and it is made clear that real property loans include loans to finance the acquisition or development of land which is to become residential property if there is assurance that the building will actually occur within a period of 3 years (with retroactive disqualification of the loan if this does not occur). The committee amendments also make it clear that an apartment building with a few commercial establishments in it qualifies as residential property for this purpose if 80 percent of the usable space in the building is residential space.

The qualifying assets also may include certain liquidity items, including cash, time and demand deposits in banks, loans secured by a deposit (or share) of a member, obligations of the United States and stock or obligations of an instrumentality of the United States or obligations of a State or local governmental unit whose interest payments are not excludable from gross income. This last item reflects a change from present lay under which tax exempt bonds are considered as qualifying investments for purposes of the investment standard (for savings and loan associations), but because they are tax-exempt they give rise to no income on which the 60-percent deduction is based; consequently, under the House bill and committee amendments such assets are to be excluded from qualifying assets.

The committee amendments also give savings and loan associations and mutual saving banks the option of computing their bad debt reserves on the basis of the commercial bank formula (1.8 percent of eligible outstanding loans plus their actual losses on ineligible loans), in lieu of the bad debt reserves outlined above. An institution may use either the percentage deduction method or the commercial bank formula method in any year, but not both. In making this computation, the institution would apply the 1.8 percent to the eligible outstanding loans (using only those loans eligible for this formula), deduct the existing balance of the reserve, and the difference would be the addition that may be made to the reserve for that year.

In determining the existing balance of the reserve for eligible loans when an institution elects to use this formula to compute its bad debt reserve deduction, an institution would combine all its existing reserves (its qualifying, nonqualifying, and supplemental reserves), and the total would be treated as the reserve for eligible loans. The institutions will also be allowed to take a deduction for their actual losses on their ineligible loans. Institutions availing themselves of this option will not be permitted to derive undue advantage from switching from one method of computing bad debt reserves to another. This is because the committee amendments require such institutions to establish bad debt reserves for each method of computing reserves so that in any year an institution switches to another reserve method it will be able to add to that reserve only the amount that would have been permitted had it been consistently on that reserve method throughout the years.

The committee amendments do not include the House provision to permit these institutions to carry back net operating losses for ten years instead of three years as under present law. The House provided for this more liberal carryback of net operating losses for banks because it believed that such treatment was needed to avoid possible hardship in view of the fact that the bad debt reserves of these institutions were to be brought down significantly. Such an expansion in the carryback period, however, is not needed under the committee's provision which allows these institutions to build up their bad debt reserves by deducting 50 percent of their taxable income or by using the commercial bank formula.

The committee's bill also does not include the House provision that would allow a new institution to use the industrywide average for making additions to its bad debt reserves during its first 10 years of existence. The committee believes that this provision is no longer necessary since a new institution can, under the committee's bill, use the 50 percent of taxable income deduction or the commercial bank formula, which should be sufficient to protect its investments during its beginning years.

Effective date.—These amendments under both the House bill and the committee amendments are effective for taxable years beginning after July 11, 1969.

Revenue effect.—The revenue increases under these amendments are estimated at $30 million in 1970, $60 million by 1972, and $75 million in 1974 and later years.

4. Treatment of Bonds, etc., Held by Financial Institutions (sec. 433 of the bill and sec. 582 of the code)

Present law.—Commercial banks, mutual savings banks and savings and loan associations receive special tax treatment in regard to their transactions in bonds and other corporate and governmental evidences of indebtedness. Unlike other taxpayers, they are allowed (under sec. 582 of the code) to treat any excess of losses over gains from such transactions as an ordinary loss and may deduct this loss without limit from ordinary income. Small business investment companies also are presently allowed ordinary loss treatment on certain convertible debentures (under sec. 1243 of the code). However, banks receive the same treatment as other corporate taxpayers when they have an excess of long-term capital gains over capital losses from such transactions in that such gains are treated as long-term capital gains for tax purposes.

In other words, these financial institutions receive nonparallel treatment with regard to their capital gains and capital losses on bonds and other corporate and governmental evidences of indebtedness. A net gain on bonds is taxed as a capital gain; but a net loss on bonds is deducted against ordinary income.

Reasons for change.—The nonparallel treatment of gains and losses on bond transactions of banks was adopted in 1942 in part to encourage financial institutions to support the large new issues of bonds which were then being offered to help finance the war. The committee believes, however, that in practice, this treatment has inequitable results. Transactions of financial institutions in corporate and government bonds and other evidences of indebtedness do not appear to be true capital transactions; they are more akin to transactions in inventory or stock in view of the size of the bank holdings of these items and the extent of their transactions in them. Moreover, financial institutions now maximize their tax advantages by arranging their transactions in bonds in the light of existing market conditions in order to realize gains in selected years and losses in other years. This enables them to report their gains as capital gains for tax purposes and their losses as ordinary losses chargeable against regular income. The result is to permit financial institutions to reduce their taxable liability and to receive preferential treatment over other taxpayers.

Explanation of provision.—Both the House bill and the committee amendments eliminate the present preferential treatment accorded to financial institutions' transactions in corporate and Government bonds and other evidences of indebtedness by providing parallel treatment of gains and losses on these transactions. Under the bill, financial institutions are to treat net gains from these transactions as ordinary income instead of as capital gains; they will continue to treat net losses from such transactions as ordinary losses as under present law.

For consistency, the parallel treatment is to apply to transactions not only in Government and corporate evidences of indebtedness but in all evidences of indebtedness. Theoretically, it would be possible to provide parallel treatment for such transactions by treating the gains as capital gains and the losses as capital losses. However, the ordinary income tax treatment provided by the bill is a preferable means of achieving such parallel treatment for two reasons: (1) it recognizes that transactions by financial institutions in evidences of indebtedness are not true capital items, but rather are more akin to transactions in inventory or stock items and (2) the ordinary income tax route, by allowing losses in such transactions to be treated as ordinary losses, gives financial institutions more effective tax relief for their losses.

The committee amendments, however, change the House provision to provide a special transitional rule designed to recognize the investment problems of the financial institutions, which already have acquired securities under the assumption that they would be able to continue the treatment accorded under present law. Under this transitional rule, gains from bonds owned by a financial institution on July 11, 1969, are to continue to receive capital gains treatment if the gain is realized within 5 years from this date. In applying this transitional provision, gains and losses from bonds eligible for the transitional treatment are to be merged with gains and losses on bonds purchased after July 11, 1969. This procedure of merging gains and losses on bond sales is necessary in order to prevent institutions from taking capital gains treatment on bond sales eligible for the transitional relief in the same year that they take ordinary loss treatment on losses incurred on securities purchased after July 11, 1969. This is necessary to prevent financial institutions from receiving more favorable tax treatment during the transition period than they received prior to the effective date the provision.

The committee's provision, in much the same manner as the House bill, provides that small business investment companies and business development corporations are to receive the same treatment as other financial institutions with regard to their gains and losses on bond transactions. However, since these two types of organizations presently receive capital gain and capital loss treatment on their bond transactions (except for certain convertible debentures in the case of small business investment companies), the committee has added a provision which allows small business investment companies and business development corporations to elect whether gains and losses incurred on bonds sold during the 5-year transition period will receive regular capital gain and capital loss treatment or ordinary income and loss treatment. This election is to be made for the entire 5-year period and is to be irrevocable. This, in effect, means that these organizations have the choice to continue their present capital gain and capital loss tax treatment during the entire 5-year transition period or have the new ordinary income and loss treatment applying immediately upon the effective date of this provision.

Effective date.—This provision is to apply with respect to taxable years beginning after July 11, 1969.

Revenue effect.—The revenue increases under this provision are estimated at $5 million annually for the years 1971 through 1973, at $10 million in 1974 and $50 million when fully effective.

5. Mergers of Savings and Loan Associations (sec. 432 of the bill and sec. 593(f) of the code)

Present law.—Under present law a taxpayer which has previously deducted additions to its bad debt reserve for tax purposes must restore the reserve to income when the need for the reserve ceases. An example of a situation where a taxpayer's need for a bad debt reserve ceases is where the taxpayer sells all of its assets including its accounts receivable.

In general, where there is a tax-free merger or reorganization the need for the bad debt reserve is considered to continue and, accordingly, the acquired corporation is not required to restore the reserve to income and it is carried over to the acquiring company. On the other hand, where a transaction is a purchase of assets or is treated as a purchase of assets (i.e., where a corporation purchases the stock of another corporation which it then liquidates under sec. 334(b)(2)), the need for the reserve is considered to cease and, accordingly, it must be restored to income.

In the case of mergers or reorganizations of savings and loan associations, the status of the reserves for losses on loans also depends on whether for tax purposes the merger is characterized as a tax-free reorganization or as a taxable sale. In general, if the merger or reorganization is tax-free, then the bad-debt reserve of the acquired association is carried over; howevr, if the merger is not tax-free, then the bad-debt reserve is restored to income and taxed (sec. 593(f)).

General reason for change.—Where there is a merger of savings and loan associations which is treated under present law as a tax-free reorganization (or liquidation), present law has been interpreted as not requiring the acquired association to restore its bad debt reserve to income. However, since present law is not explicit on this point, it is usually necessary for the associations to obtain a ruling on this point from the Internal Revenue Service. The delay involved in this may be detrimental in the case of supervisory mergers. (A supervisory merger is one encouraged or instituted in the public interest by the Federal Savings and Loan Insurance Corporation and the Federal Home Loan Bank Board involving one or more savings and loan associations with financial or managerial problems.) There does not appear to be any necessity to require the association to acquire a ruling in these cases.

Explanation of provision.—The committee amendments provide that in those cases where section 381 applies (relating to carryovers in certain corporate acquisitions which qualifiy as tax-free reorganizations or liquidations), the bad-debt reserves would not have to be restored to income (i.e., the provisions of sec. 593(f) are not applicable). This amendment is intended merely to be declaratory of existing law where the bad-debt reserve is carried over to the acquiring corporation (under sec. 381). There is no comparable provisions in the House bill.

Effective date.—This provision is to apply with respect to taxable years beginning after July 11, 1969.

6. Foreign Deposits in U.S. Banks (sec. 435 of the bill and secs. 861 and 2104 of the code)

Present law.—Present law provides special rules for the treatment under the income tax and and the estate tax of U.S. bank deposits, and the interest thereon, of foreign persons (i.e., nonresident alien individuals and foreign corporations).

A foreign person generally is subject to U.S. tax only on the income he derives from the United States. Although interest paid by a U.S. person to a foreign person generally is considered to be U.S. source income, a special rule provides that interest on U.S. bank deposits which is paid to foreign persons, and which is not effectively connected with the conduct of a trade or business carried on by the person within the United States, is not to be treated as U.S. source income. In other words, this type of interest income generally is not subject to U.S. tax.

The estate tax is imposed, in the case of a nonresident alien individual, generally only on the individual's property which is located in the United States. A special rule provides that a nonresident alien individual's bank deposits in the United States are not to be considered property located in the United States and, thus, are not subject to the estate tax, if the interest on the deposits was not taxable under the special income tax rule. Under present law, the special bank deposit rules are to cease to apply at the end of 1972. In other words, after 1972 the interest on these bank deposits would be subject to income tax and the bank deposits themselves would be subject to the estate tax.

The rules provided under present law in the case of deposits by foreign persons with a U.S. banking branch of a foreign corporation differ somewhat from the rules described above with respect to deposits in U.S. banks. In the case of a U.S. banking branch of a foreign corporation, the interest on the bank deposit is not considered U.S. source income even if it is effectively connected with the conduct of a U.S. trade or business carried on by the foreign person (except where all or a portion of the interest of the foreign corporation generally is treated as U.S. source income because 50 percent or more of the corporation's income is effectively connected with a U.S. business). In addition, deposits of a nonresident alien in a U.S. banking branch of a foreign corporation are not considered to be property located in the United States for estate tax purposes. Under present law, these special rules are to cease to apply at the end of 1972. Thus, after 1972, interest on deposits with a U.S. banking branch of a foreign corporation would be considered U.S. source income and the bank deposits themselves would be considered located in the United States.

General reasons for change.—In the Foreign Investors Tax Act of 1966, Congress provided that the special treatment accorded U.S. bank deposits of foreign persons should be terminated. It was concluded that there was no reason to treat the interest income on these deposits, which so clearly is derived from U.S. sources, as not being from U.S. sources and thereby allowing the interest to escape U.S. taxation. The same conclusion was reached with respect to the special treatment provided these bank deposits in the case of the estate tax.

At that time, however, it was believed that an immediate elimination of the special rules for the treatment of these bank deposits might have a substantial adverse effect on our balance of payments. In view of this, it was decided that the elimination of the special rules should be postponed until the end of 1972. This was to allow Congress time to evaluate and reconsider the balance of payments situation, in order to determine whether at that time the impact of removing the special treatment on the balance of payments would be substantial.

In view of the continuing deficit in the U.S. balance of payments, the committee agrees with the House that it is appropriate to further postpone the removal of the special treatment provided for U.S. bank deposits of foreign persons until the end of 1975. The committee agrees with the House, however, that there is no justification (other than balance-of-payments considerations) for treating this type of income, which so clearly is derived from U.S. sources, as being from foreign sources. The effect of the special rule (and the similar estate tax special rule) is to permit U.S. taxation to be avoided. Nevertheless, the present balance-of-payments situation might be adversely affected to a substantial degree if the special treatment were removed as provided in present law at the end of 1972.

In anticipation of the elimination of the special treatment, foreign persons might withdraw their bank deposits from the United States during the next year or two. This outflow of funds from the United States, if it were to occur, would further harm the balance of payments. The further postponement of the effective date of the removal of the special treatment will forestall this possibility and will provide Congress with an additional opportunity to reconsider the balance-of-payments situation and the impact on that situation of the removal of this exemption.

In addition to postponing the effective date of the removal of the special treatment provided for deposits of foreign persons in U.S.

banks, the House bill also postponed the effective date provided in present law for making the treatment accorded deposits in U.S. banking branches of foreign corporations the same as that accorded deposits in U.S. banks. The effect of this postponement is to continue the exemption from income tax for interest on deposits of foreign persons in U.S. banking branches of foreign corporations, even where the interest is effectively connected with a U.S. business, and also to continue the exemption from the estate tax imposed on nonresident alien individuals for the deposits themselves. The committee does not believe there is any reason to postpone the parallel treatment of deposits in the two types of banks. In other words, the special treatment should be available with respect to deposits in either type of bank only if the interest on the deposit is not effectively connected with a U.S. business of the foreign recipient. Accordingly, the committee has amended the House bill to provide for this parallel treatment.

Explanation of provision.—Both the House bill and the committee amendments provide that in the case of deposits in U.S. banks, the special income and estate tax rules regarding U.S. bank deposits (including deposits with savings and loan associations and certain amounts held by insurance companies) of foreign persons are to continue to apply until the end of 1975. As a result, interest on U.S. bank deposits of foreign persons, which is not effectively connected with a U.S. business of the foreign person, is to continue to be treated as from foreign sources (and, thus, exempt from U.S. income tax), and the deposits themselves will continue to be treated as located outside of the United States (and, thus, not subject to the U.S. estate tax) until the end of 1975.

As indicated above, the committee amendments also revise the treatment of deposits in U.S. banking branches of foreign corporations to provide the same treatment as exists when the deposits are in U.S. banks. Under the committee amendments, interest on a deposit of a foreign person in a U.S. banking branch of a foreign corporation is to be treated as from foreign sources (and, thus, not subject to U.S. income tax) only if the interest is not effectively connected with a U.S. business carried on by the foreign person. In addition, the deposits themselves are to be treated as located outside the United States (and, thus, not subject to the U.S. estate tax imposed on nonresident alien individuals) only if the interest is not effectively connected with such a U.S. business. As is true in the case of deposits of foreign persons in U.S. banks, these special rules would cease to apply after 1975.

Effective date.—The changes made by the committee amendments in the case of deposits in U.S. banking branches of foreign corporations are to apply for income tax purposes with respect to interest paid after 1969 and for estate tax purposes with respect to nonresident aliens dying after 1969.

N. DEPRECIATION ALLOWED REGULATED INDUSTRIES

(Sec. 441 of the bill and sec. 167(l) of the code)

Present law.—Regulated industries may make the same elections as other taxpayers regarding depreciation of their business property. About half the regulatory agencies require utilities that use accelerated depreciation to "flow through" the resulting reduction in Federal income taxes currently to income. (Where the utility is earning the maximum allowed by law or regulations, this results in flowing through the tax reduction to the utility's current customers.) Other agencies permit the utilities they regulate to "normalize" the deferred tax liabilities resulting from accelerated depreciation. (This involves the utility retaining the current tax reduction and using this money in lieu of capital that would otherwise have to be obtained from equity investments or borrowing.) Some agencies insist that utilities subject to their jurisdiction use accelerated depreciation for tax purposes and, in a few rate cases, such agencies have treated the utilities they regulate as though they used accelerated depreciation (and flowed through the resulting tax reduction), even though the utilities may have in fact used straight-line depreciation.

General reasons for change.—The trends of recent years are shifts from straight line to accelerated depreciation and shifts from normalization to flow-through, often against the will of the taxpayer utilities. In general, flow through to customers doubles the tax revenue loss involved in shifting from straight line to accelerated depreciation. It is understood that continuation of these trends would shortly lead to revenue losses of approximately $1.5 billion. Such a revenue loss from this item is unacceptable at this time. On the other hand, a rule requiring all such utilities to shift to straight line depreciation would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Consideration of legislative action in this area is complicated by the fact that many utilities do not have effective monopolies while others do; many utilities are in growing industries while others are losing ground; many utilities compete (to the extent they face any competition) only with other regulated utilities while others compete with businesses not subject to governmental rate regulation.

Accordingly, the committee agrees with the House that it is appropriate to in general "freeze" the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more flourishing utility industries. No change is made regarding utility industries whose members are, by and large, earning well below their permitted rates of return.

Explanation of provisions.—Both the House bill and the committee amendments provide that if a company (a) is in one of the regulated industries to which the bill applies and (b) at present takes accelerated depreciation and normalizes, or takes straight line depreciation, then the company is not to be permitted to take accelerated depreciation on its tax return unless it normalizes on its regulated books of account for rate-making purposes. Other companies—those that now flow through, as well as those in other regulated industries—are not limited by this general rule of the bill.

Both the House bill and the committee amendments provide that in the case of existing property the following rules are to apply:

(1) If straight line depreciation is presently being taken, then no faster depreciation is to be permitted as to that property.

(2) If the taxpayer is taking accelerated depreciation and is "normalizing" its deferred taxes, then it must shift to the straight line method unless it continues to normalize as to that property.

(3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer would continue to do so (except as provided under the committee amendments which are discussed below), unless the appropriate regulatory agency permits a change as to that property.

Both versions of the bill in the case of new property have the effect that if the taxpayer presently flows through to its customers the benefits of deferred taxation, then it would stay on accelerated depreciation and flow through unless the regulatory agency permits it to change (or unless the exception under the committee amendments pointed out below applies). In all other cases, accelerated depreciation is to be permitted only if the utility normalizes the deferred income taxes. The taxpayer is permitted to elect straight line depreciation as to this new property. If the taxpayer seeks to use accelerated depreciation, the regulatory agency may permit it to normalize; if the regulatory agency does not, the taxpayer must use straight line depreciation.

The bill does not change the power of the regulatory agencies in the case of normalization to exclude the normalized tax reduction from the base upon which the agency computes the company's maximum permitted profits.

Both the House bill and the committee amendments provide that the rules set forth above are to apply to property used predominantly in the trade or business of the furnishing or sale of—

(1) Electrical energy;
(2) Water;
(3) Sewage disposal services;
(4) Gas through a local distribution system;
(5) Telephone services; or
(6) Transportation of gas by pipeline.

In all of the above cases the rules of the bill apply if the rates for such furnishing or sale are regulated by a utilities commission or similar agency.

The committee amendments, while in most respects the same as the House provisions, differ in one principal area. The amendments permit an election to be made within 180 days after the date of enactment of the bill for a utility covered by this provision to shift from the flow-through to the straight-line method, with or without the permission of the appropriate regulatory agency, or permit it with the permission of the regulatory agency to shift to the normalization method (that is, to come under general rules of the bill).

This election applies both as to new and existing property. In order to provide sufficient time for the regulatory agency to authorize an electing company to change its books from flow-through to normalization and to use normalization in computing the rates charged to the company's customers, the bill provides that the election will take effect at the start of the company's first taxable year beginning after December 31, 1970. If the books and rates have been conformed to normalization by then, the company may continue to use accelerated depreciation so long as it continues to normalize; if not, the company must use only straight line depreciation. Since the company would no longer be permitted to use accelerated depreciation (unless the agency later permits it to normalize), the agency would not be able to impute the use of accelerated depreciation with flow-through. In other words, a company that makes this election would be under the general rule of the bill after its election takes effect.

A number of other changes are also made by the committee amendments.

Oil pipelines are removed from the category of companies covered by the bill and regulated steam producers are included in the categories covered. In addition, Comsat, which was specifically excluded under the House bill, is included in industries covered by the provision.

In some jurisdictions the purpose and effect of normalizing is accomplished by additions to a reserve for depreciation. The committee amendments permit such a definition of normalization and do not require that additions be to a separate account described as a "reserve for deferred taxes."

The committee amendments provide that the requirement of normalizing is not met by simply normalizing the regulated books of account of the utility if these books of account may be ignored by the regulatory agency in setting rates. Under the committee amendments, while the regulated books of account are to be used as the basic source of information, these books are not to control if the current rates of the utility are set by reference to the flow-through method. This is done because the use of flow-through in setting rates would produce the revenue loss the bill seeks to avert.

The committee amendments provide that a taxpayer is not to be treated as normalizing unless the entire deferral of taxes resulting from the difference between (a) the depreciation method used in the regulated books of account and (b) the accelerated depreciation deducted on the return is normalized. However, this rule is to be applied for the future only.

Under this rule, differences in the amount of depreciation expense need not be normalized if they result from such differences as (a) use of so-called "guideline lives" for tax purposes and "engineering lives" on the regulated books and (b) different bases for the property because the agency requires that certain carrying charges be capitalized even though for tax purposes they may be deducted or because the agency requires a carryover basis in the case of a purchase of property from another regulated utility even though for tax purposes the basis is what the purchasing company paid for the property.

However, any difference resulting from a faster method of depreciation (including the use of a faster declining balance rate) must be normalized. For example, if a company takes straight line depreciation on its regulated books of account and 200 percent declining balance on its tax return, it does not meet the test of the bill if it normalizes only with respect to the difference between 200 percent declining balance and 150 percent declining balance.

Under the committee amendments, the status of a company as to whether it is on straight line, normalizing, or flow through is to be determined as of August 1, 1969 (instead of July 22, 1969, under the House bill).

Accordingly, the determination of the present method of depreciation generally is to be made by reference to the return for the last taxable year for which a return was filed before August 1, 1969. (It is expected that in most cases this will be the return for calendar

1968). Property not reflected on that last return as public utility property, which is used as public utility property before January 1, 1970, is to be treated the same as property of the same kind or, if there is no property of the same kind, property of the most nearly similar kind that is reflected on that return. If the company's last tax return reflected two methods of depreciation for a kind of property—for example, where it used straight line depreciation for property put in service through 1964 but used 200 percent declining balance for property put in service since then—the method to be used for property not reflected on the return would be 200 percent declining balance, the method used for the newer property.

Under another provision of the bill (sec. 521, described below), real estate depreciation allowances have been revised, and the most accelerated methods of depreciation (the 200-percent declining balance and sum of the years-digits methods) are no longer permitted with respect to new real estate (other than residential housing); later-acquired used real estate is limited to straight line depreciation. The committee amendments provide that in the case of real estate to which the new limitations on allowable depreciation for regulated utilities apply, that method permitted by the new limitations which is most nearly comparable to the method of depreciation used on the taxpayer's pre-August 1, 1969, return is to be considered to be the taxpayer's present method of depreciation. For example, if the taxpayer used 200 percent declining balance for its new property on its latest tax return filed before August 1, 1969, and in the future acquires new public utility property of the same kind, the 150-percent declining balance method would be its most nearly comparable method.

Under the committee amendments, the status of a company is not necessarily to be determined only by the method of depreciation used on its tax return. Utilities that have used accelerated depreciation (with flow through) in computing their tax expense on their regulated books of account for the latest monthly period ending on or before August 1, 1969, are to be permitted to elect accelerated depreciation (with flow through) for such property and for future acquisitions. In addition, the committee amendments provide that a utility which has filed a request with the Internal Revenue Service for permission to change from straight line to accelerated depreciation is to be permitted to make that change for such property and for future acquisitions.

Also, if a company adopts flow-through in compliance with a change authorized within 90 days after the date of enactment of the bill by the appropriate State agency pursuant to proceedings instituted by that agency before April 22, 1969 (the date the Treasury Department first made public its recommendations on this subject), during which the company proposed before April 22, 1969, to reduce its rates immediately after being authorized by the State agency to adopt flow-through, then it will be treated as a flow-through company. These provisions are intended to permit companies that have effectively committed themselves to a particular status in their official dealings with the appropriate government agencies to be treated as having attained that committed status.

When the term "straight line depreciation" is used in the above description (and also with regard to the earnings and profits and the real estate depreciation provisions, described below) it is intended to encompass also other ratable methods such as units of production and machine hours (but not the so-called "forecast of income" method).

The provision also authorizes the use of regulations to provide for proper application of this provision where more than one agency supervises the activities of a company if the several agencies apply different rules to the company's property, where companies are involved in reorganizations, mergers, or other acquisitions, and in other circumstances in order to carry out the purposes of this provision.

Effective date.—Under the committee amendments, the new rules are to apply to all taxable years for which a return has not been filed before August 1, 1969, even though those years may have ended before that date.

Revenue effect.—The revenue increases under these amendments are estimated at $60 million in 1970, $260 million in 1974, and $310 million in 1979. This does not take into account any possible elections of those on flow through to shift, within a 180-day period, to straight line or normalization (if permitted by their regulatory agency) with respect to both future and existing property, since it is not possible to know how many will make such an election.

O. TREATMENT OF DEPRECIATION FOR EARNINGS AND PROFITS

(Sec. 442 of the bill and sec. 312(m) of the code)

Present law.—A dividend is defined under present law as a distribution of property (which includes money) by a corporation to its shareholders out of either current or accumulated earnings and profits. If a distribution exceeds the corporation's earnings and profits, then the excess is a "tax-free dividend" (not currently taxable to the shareholder) which reduces his cost basis in the stock (increasing capital gain or reducing capital loss if the stock is sold by him). Earnings and profits generally are computed by reference to the method of depreciation used in computing the corporation's taxable income and so are reduced by the amount of depreciation deducted by the corporation on its return.

General reasons for change.—Tax-free dividends from accelerated depreciation—in effect, resulting in current avoidance of tax at ordinary income rates in exchange for possible postponed tax at long-term capital gains rates—appear to be increasing in a number of industries. Especially among utilities, a number of companies are regularly making such distributions. It was indicated that in 1968 private power companies alone made such tax-free distributions totaling approximately $260 million. Statistical information is not readily available in the real estate industry on this point, but it is understood that substantial amounts of corporate distributions in this industry are also tax-free. Availability of these tax benefits is generally unrelated to the purposes of accelerated depreciation and is of greatest value to individual stockholders in high tax brackets.

The committee agrees with the House that corporations should not be allowed to continue to make these types of nontaxable distributions. In addition to affecting the ability of corporations to make nontaxable distributions, however, the House bill also would have a significant impact on various rules governing U.S. taxation of foreign income. This provision of the House bill would reduce the amount of allowable deemed paid foreign tax credits (i.e., the foreign tax credit allowed for foreign taxes paid by a foreign subsidiary with respect to its earnings from which it pays a dividend to its U.S. parent). Similar problems would arise under other provisions of the code which relate to a determination of earnings and profits of a foreign corporation including subpart F, the minimum distribution provision of section 963, and sections 1246 and 1248 which relate to the sale of stock of certain foreign corporations.

In view of the very substantial changes in the taxation of operations conducted abroad through foreign corporations which would be affected by this provision, the committee does not believe it is appropriate at this time to apply this type of provision to foreign corporations operating abroad. It would appear appropriate for this matter to be considered in conjunction with the general revision of the taxation of foreign income which the Treasury has indicated it is studying and on which it will report to Congress. It is contemplated that the rules developed by the Treasury as a result of this study will provide for consistent treatment of foreign branches and foreign subsidiaries.

Explanation of provisions.—Both versions of the bill provide that, for the purpose of computing its earnings and profits, a corporation is to deduct depreciation on the straight line method, or on a similar method providing for ratable reductions of depreciation over the useful life of the asset. Such similar ratable methods would include units of production and machine hours but (except in unusual personal property cases such as movie film) would not include the so-called "forecast of income" method. In effect, this will conform the law regarding depreciation to present practice regarding depletion. (Regulations § 1.312–6(c)(1) provides that cost depletion must be used in determining earnings and profits of a corporation that uses percentage depletion in computing its taxable income.) This provision will also apply to corporations which use the rapid methods of amortization under sections 168, 169, or 184 (added by this bill), but it is not intended to affect the amount of depreciation that may be deducted by a corporation under sections 167 or 179 or the amortization deduction allowable under sections 168, 169, or 184 in determining taxable income. Similarly, the provision does not affect the computation of real estate investment trust taxable income in determining whether the trust paid dividends equal to or in excess of 90 percent of its taxable income, but the provision will apply to a real estate investment trust for the purpose of computing its earnings and profits and, therefore, the taxability of distribution to shareholders or holders of beneficial interests in such a trust.

When property depreciated under this rule is sold, the amount of gain or loss taken into earnings and profits is to be adjusted to compensate for any difference between the tax return depreciation deductions and the earnings and profits depreciation deductions up to the time of sale. This results from the application of existing law, which requires the corporation to adjust its earnings and profits basis by the amount of depreciation allowed in computing earnings and profits and not by the amount of depreciation taken as a deduction on its income tax return.

For the reasons indicated above, the committee amendments provide that this rule as to the method of computing earnings and profits is not to apply for purposes of the various determinations relating to the earnings and profits of foreign corporations in the case of a foreign corporation if less than 20 percent of its gross income for the taxable year in question is derived from sources within the United States. Thus, for example, the amount of the deemed paid foreign tax credit allowed a company receiving dividends from such a foreign corporation is to be computed as under existing law and will not be affected by this provision of the bill.

Effective date.—This provision is to apply to the computation of earnings and profits with respect to taxable years beginning after June 30, 1972. The 3-year delay is expected to be sufficient to avoid drastic reductions in the market values of the shares of corporations which now make such tax-free distributions.

Revenue effect.—The revenue increase under this amendment is estimated at $80 million annually beginning in 1973.

P. NATURAL RESOURCES

1. Percentage Depletion (sec. 501 of the bill and sec. 613 of the code)

Present law.—Starting in 1926, percentage depletion for oil and gas wells has been allowed at the rate of 27½ percent of the gross income from the property. In subsequent years, starting in 1932, percentage depletion at lower rates was extended to most all other minerals.

At present, the percentage depletion rates are 27½ percent for oil and gas wells; 23 percent for sulfur, uranium, and an extended list of minerals; 15 percent for metal mines, rock asphalt, vermiculite, and certain types of clay; 10 percent for coal and a limited group of other minerals; 7½ percent for clay, shale, and slate used for specified purposes; and 5 percent for such items as gravel, peat, and sand, and certain minerals from brine wells. In addition, a 15-percent rate applies to a final category which contains an extended series of minerals and also includes all other minerals (unless sold for riprap, ballast, road material, rubble, concrete aggregates, or for similar purposes, in which case the applicable rate is 5 percent). Percentage depletion is not granted in the case of soil, sod, dirt, turf, water, or mosses or minerals from sea water, the air, or similar inexhaustible sources.

Percentage depletion generally applies to the specified items regardless of whether the pertinent property is located in the United States or abroad. However, except for sulfur and uranium, the 23-percent percentage depletion rate applies only to deposits in the United States, and foreign deposits of the other minerals in this category are subject to percentage depletion at the 15 percent rate.

General reasons for change.—Percentage depletion was adopted in 1926, when the prior allowances based on discovery value in the case of oil and gas proved difficult to administer and produced varying results. At that time, it was recognized that percentage depletion could permit taxpayers to recover amounts in excess of their investments. This was deemed justified on the ground it would have the beneficial effect of stimulating exploration for, and discovery of, new reserves of vitally needed oil and gas.

The committee agrees with the House that the percentage depletion rate provided for oil and gas wells is higher at the present time than is needed to achieve the desired increase in reserves. The committee does not believe, however, that these rates should be decreased to the extent provided by the House bill in order to achieve a reasonable relation to the degree of stimulant needed from the percentage depletion deduction at the present time. In addition, it does not appear appropriate to the committee to reduce the percentage depletion rates provided for minerals other than oil and gas wells (as would be done under the House bill) since it is much less clear in these cases that there is a disparity between the level of the rates presently provided and the level which is appropriate to attain the desired effect on reserves. The committee also does not believe it is desirable to eliminate, as the House bill would do, percentage depletion on foreign oil and gas wells. This probably would not result in a significant increase in U.S. revenues, since foreign countries probably would raise their tax rate on income from oil and gas production and thereby reduce, because of the foreign tax credit, any additional revenues the United States might receive. Indeed, the committee was advised that some countries have provisions in their taxing programs automatically increasing their tax to take advantage of higher U.S. taxes which can be offset by our foreign tax credit. Thus, the end result of eliminating percentage depletion on foreign oil and gas deposits would merely be to increase the foreign tax burden imposed on U.S. businesses. This result is indicated by the fact that while the U.S revenue gain from this provision of the House bill is expected to be $25 million in 1970, it is expected that by 1972 this U.S. revenue gain will have decreased to a negligible amount.

Explanation of provisions.—The committee amendments provide that the percentage depletion rate for oil and gas wells is to be reduced from the present rate of 27½ percent to 23 percent. As under present law, percentage depletion is to apply to both domestic and foreign oil and gas wells. Under the House bill, the percentage depletion rate for oil and gas was decreased from 27½ percent to 20 percent, and percentage depletion was made unavailable in the case of foreign production of oil and gas.

In the case of other minerals, the committee amendments provide that the percentage depletion rates of existing law are to continue to apply. The House bill generally reduced these rates by about 25 percent (except for gold, silver, oil shale, copper, and iron ore, which were left at the present rate of 15 percent). The percentage depletion rates under present law, which are retained by the committee, and the rates under the House bill in the case of these other minerals are as follows:

[In percent]

	Present rate (committee amendments)	Rate provided by House bill
Sulfur and uranium, and specified minerals from domestic deposits	23	17
Gold, silver, oil shale, copper, and iron ore from domestic deposits	15	15
Remaining minerals now at 15 percent	15	11
Asbestos, coal, sodium chloride, etc	10	7
Clay, shale, and slate for specified uses	7½	5
Gravel, sand, and other minerals now at 5 percent	5	4

Effective date.—The changes in percentage depletion rates are to be effective for taxable years beginning after October 9, 1969.

Revenue effect.—It is anticipated that this provision will result in an annual revenue gain of $175 million.

2. Net Income Limitations on Percentage Depletion Deductions (sec. 502 of the bill and secs. 613(a) and 318 of the code)

Present law.—Under present law, the percentage depletion allowance is limited to a maximum of 50 percent of the taxable income from the property, computed before any allowance for depletion. If depletion based on cost is higher than percentage depletion, the higher amount is allowed as a deduction.

General reasons for change.—The committee believes that with respect to gold, silver, and copper additional incentives should be provided. However, because of the 50 percent limitation, producers of these minerals are often unable to deduct the full amount of percentage depletion available at existing rates, and additional incentives cannot effectively be provided by increasing the depletion rates available with respect to these minerals. The committee has therefore decided to provide a special 70 percent net income limitation on percentage depletion with respect to gold, silver, and copper.

The committee has also included a provision raising the 50 percent limitation to 65 percent for taxpayers with aggregate gross income from oil and gas wells of less than $3 million. This step was needed to aid small producers whose percentage depletion is frequently limited by the existing 50 percent taxable income limitation.

Explanation of provision.—The committee amendments add a provision to the House bill to provide that to the extent the taxable income from a mineral property (computed without allowance for depletion) is attributable to gold, silver or copper, the limitation on the percentage depletion deduction is to be 70 percent, instead of 50 percent, of the taxable income from the property. The limitation on the deduction with respect to the remainder of the production from the mineral property is to be 50 percent of the portion of taxable income from the property attributable to that production. The portion of the taxable income from a mineral property which is attributable to gold, silver or copper is to be determined by reference to the portion of the taxpayer's gross income from the property (excluding rents or royalties paid or incurred by the taxpayer) which is from gold, silver and copper. For example, if 40 percent of a taxpayer's gross income from a mineral property was from silver and the remaining 60 percent of the gross income from the property was from lead, then the limitation on the percentage depletion deduction with respect to that property would be 70 percent of 40 percent of the taxable income from the property plus 50 percent of the remaining 60 percent of the taxable income from the property.

Under the committee amendments a special limitation also is provided with respect to oil and gas wells. In the case of a taxpayer whose aggregate gross income from oil and gas wells during the taxable year is less than $3 million, the limitation on the percentage depletion deduction is to be 65 percent instead of 50 percent, of his taxable income from the property (computed without allowance for depletion). In determining whether a taxpayer's gross income for the taxable year from oil and gas wells is less than $3 million, he is to be considered as having received the gross income from oil and gas wells received by another person to the extent he would be treated as owning stock owned by that person under the attribution rules of section 318. For this purpose, however, there is to be family attribution only between husband and wife, and between parents and minor children and grandchildren. In addition, there is to be attribution from a corporation to a shareholder, and vice versa, where the stockholder has at least a 10 percent, rather than a 50 percent, interest in the corporation. If the taxpayer is a component member of a controlled group of corporations as defined in section 1563, the taxpayer is to be considered as having received the gross income from oil and gas wells received by each member of the controlled group.

Effective date.—The amendments made by this section are to apply to taxable years beginning after October 9, 1969.

Revenue effect.—It is estimated that this provision will result in an annual revenue loss of $20 million.

3. Minerals Obtained from Saline Lakes (sec. 503 of the bill and sec. 613(b) of the code)

Present law.—Under present law, percentage depletion is not allowable with respect to minerals from sea water, the air, or similar inexhaustible sources. The Internal Revenue Service has taken the position that percentage depletion is not permitted with respect to minerals taken from the Great Salt Lake because it considers the Great Salt Lake (a perennial lake) to be an inexhaustible source.

General reasons for change.—The committee understands that although the water from the Great Salt Lake is replenished to a certain extent, the replenishment has been diminished in recent years by water conservation practices in the surrounding area. The committee has therefore decided to permit percentage depletion with respect to minerals (other than salt) extracted from the Great Salt Lake and other saline perennial lakes within the United States.

Explanation of provision.—The committee's amendment provides that for purposes of percentage depletion, minerals (other than sodium chloride) extracted from brines pumped from a saline perennial lake within the United States are not to be considered minerals from an inexhaustible source. Thus, the specified percentage depletion rates are to be available with respect to these minerals. For purposes of determining the percentage depletion cutoff point in these cases, the extraction of the minerals from the brine is to be considered an ordinary treatment process. This would not include, however, further processing or refining.

The committee's amendment is not intended to affect the availability of percentage depletion on sodium chloride from saline lakes in cases where the source of the sodium chloride is not inexhaustible.

Effective date.—This amendment is to apply to taxable years beginning after October 9, 1969.

4. Treatment Processes in the Case of Oil Shale (sec. 504 of the bill and sec. 613(c) of the code)

Present law.—Oil shale is a sedimentary rock from which liquid oil can be extracted by application of heat. Under present law, the percentage depletion allowance for oil shale applies only to the value of the rock itself after extraction from the ground and crushing.

Percentage depletion may not be computed on the value of the liquid oil which is produced by subjecting the rock to the retorting process.

General reasons for change.—Although the United States has very large reserves of oil shale, there is virtually no production of oil from this source. Existing levels of technology do not permit shale oil to be produced on a basis competitive with oil produced from wells. Both versions of the bill provide, as an incentive for investment in research and technological development in the processing of shale oil, a depletion allowance for oil produced from shale which more nearly corresponds to the depletion allowance for oil produced from wells.

Explanation of provision.—Both the House bill and the committee amendments provide that percentage depletion is to be computed in the case of shale oil on its value after extraction from the ground, crushing, loading into the retort, and retorting, but before hydrogenation, refining, or any other process subsequent to retorting.

Effective date.—The amendment is to be effective for taxable years beginning after the date of enactment of the bill.

Revenue effect.—The immediate revenue effect of this provision will be negligible because there is no significant production of oil from oil shale at the present time. However, as technological problems are solved and shale oil is produced in quantity, there will be a corresponding loss of revenue.

5. Mineral Production Payments (sec. 505 of the bill and sec. 636 of the code)

Present law.—A mineral production payment is a right to a specified share of the production from a mineral property (or a sum of money in place of the production) when that production occurs. The payment is secured by an interest in the minerals, the right to the production is for a period of time shorter than the expected life of the property, and the production payment usually bears interest. Depending on how a production payment is created, it may be classified as a carved-out production payment, or retained production payment which may then be used in a so-called A-B-C transaction.

A carved-out production payment is created when the owner of a mineral property sells—or carves out—a portion of his future production. A carved-out production payment is usually sold for cash and, quite often, to a financial institution. Under present law, the amount received by the seller of the carved-out production payment generally is considered ordinary income subject to depletion in the year in which received. The purchaser of the production payment treats the payments received as income subject to the allowance for depletion (almost always cost depletion) and thus generally pays no tax on those amounts (except for that portion of the payments which is in the nature of interest). The amounts utilized to pay the production payment are excluded from income by the owner of the property during the payout period, but the expenses attributable to producing the income are deducted by him in the year they are incurred.

A retained production payment is created when the owner of a mineral interest sells the working interest, but reserves a production payment for himself. Under present law the owner of the retained production payment receives income for which percentage depletion may be taken during the payout period, or period during which he receives a part of the production (or a payment based on production).

The purchaser of the working interest excludes the amounts used to satisfy the production payment during the payout period, but (until recently) deducted the cost of producing the minerals subject to the production payment.

The so-called A–B–C transaction is the same as a retained production payment case, except that after selling the working interest, the initial owner then sells the "retained production payment." Thus, in an A–B–C transaction, the owner of the mineral property, A, sells it to a second person, B, and reserves a production payment (bearing interest) for a major portion of the purchase price. He then sells the production payment to a third party, C, which is usually a financial institution, or, perhaps, a tax-exempt organization.

General reasons for change.—The treatment of mineral production payments under present law has resulted in what are essentially two problems, one relating to carved-out production payments and one relating to retained production payments and A–B–C transactions. In the case of the carved-out payments, by advancing the time income (but not the related expense) is reported for tax purposes, taxpayers have been able to avoid limitations based on net or taxable income—principally the 50-percent limitation on taxable income from the property for percentage depletion purposes, but also the foreign tax credit limitation, the 5-year net operating loss carryover limitation, and the 7-year investment credit carryover. In the case of A–B–C transactions, taxpayers have been able to amortize or pay off what is essentially a loan with before-tax dollars rather than after-tax dollars.

In each of the three situations (the carved-out production payment, the retained production payment, and the A–B–C transaction), the transaction is similar, in fact, to a loan transaction with the loan secured by a mortgage on the property and the "borrower" not personally liable for the loan. In a carve-out, the analogy to a loan is the borrowing of money (selling a production payment). In an A–B–C transaction, the analogy is to the sale of a property but subject to a mortgage subsequently sold to someone else.

The factual similarity between the creation of a production payment and a loan transaction and the disparate tax treatment of production payments and loans can be illustrated by examining two hypothetical A–B–C transactions, one involving an oil payment, and the other the sale of an apartment.

Assume that A sells an operating business to B—the business may be an oil well, or it may be an apartment building. However, assume that A retains the right to a production payment—a payment equivalent to the current price of a specified number of barrels of oil—or in the case of the apartment building, a mortgage, which is not much different from the production payment. Then suppose that A sells the production payment or mortgage to C.

From A's standpoint, the two transactions are treated the same—they both result in a capital gain—or loss—to A depending upon his cost or other basis whether it is the apartment building or oil well which is being sold.

However, the similarity between the oil well and the apartment building ends here. In the case of the apartment building, all of the rental income after ordinary expenses and depreciation is taxable income to B and he must pay off the mortgage out of "after tax" dollars.

In the case of the oil well, however, B is not considered as receiving the production payment at all—which, in the typical case, may well amount to as much as 90 percent of the income from the well. Thus, in this case B is, in effect, paying the production payment out of "before-tax dollars." This privilege of purchasing capital interests out of tax-free income is not a privilege accorded ordinary taxpayers. At the same time (until recently in the *Brooks* case), B, in the case of the oil well, claims the right to take the operating expenses for the entire well against his share of the income with the result he is likely to have hardly any taxes to pay while he is acquiring a full interest in the oil well.

At the same time, B is paying little or no tax in the case of the oil well, C, who is receiving the production payment is receiving cost depletion on this payment. Thus, he is amortizing his entire cost over the period he receives his payments.

The C who has the mortgage on the apartment house fares no better than his counterpart with the production payment despite the special advantages of the B with the oil well. The C with the mortgage can spread his cost over the period of the mortgage but, presumably, any excess he receives is interest income and therefore ordinary income.

The crucial difference between the A–B–C transaction in oil and the mortgage for the apartment, therefore, lies in the treatment of B and the fact that in the A–B–C transaction B can amortize C's capital interest out of tax-free dollars rather than the "after-tax dollars" he must use in the apartment case.

In recent years, the use of mineral production payments has increased substantially. In 1965, reported carved-out production payment transactions totaled $214 million. One year later, this amount had more than doubled to a figure of $540 million. This represented a revenue loss to the Federal Government of $70 million. The reported amount of so-called A–B–C transactions in 1966 totaled $1.85 billion. Moreover, the use of the A–B–C transaction has spread to industries where it previously was not used. For example, the use of production payments was almost unknown in the coal industry several years ago. However, within recent years, coal properties have been sold, subject to retained production payments of approximately $800 million.

The committee agrees with the House that there is no reason why a person who, in effect, is the borrower in a production payment transaction should be allowed to pay off the loan with tax-free dollars while a borrower of funds in any other industry must satisfy the loan out of taxed dollars. In addition, the committee agrees with the House that Congress did not intend to permit the avoidance of the limitation on depletion deductions and the mismatching of income and expenses which creates artificial tax losses by the use of production payments. Moreover, there is a substantial revenue loss which results from the use of production payments. It is estimated that the combined revenue loss from ABC transactions and carved-out production payments is between $200 and $350 million annually. An acceleration of the revenue loss can be expected unless corrective action is taken.

Explanation of provision.—For the above reasons, both versions of the bill, in general, provide that production payment transactions are to be treated as loan transactions; that is, a loan by the owner of the production payment to the owner of the mineral property. This is the same treatment as provided under present law whenever the payout of a production payment, in the case of a carve out, is in any manner guaranteed by the person who created it, or, in the case of an A-B-C transaction, is guaranteed by B, the purchaser of the working interest.

In the case of a carved-out production payment, the bill provides the payment is to be treated as a mortgage loan on the mineral property (rather than as an economic interest in the property). Thus, the proceeds received by the seller upon a sale of a production payment would not be taxable to him. However, as income is derived from the property subject to the carve out, that income would be taxable to the owner of the property, subject to the depletion allowance. The cost of producing minerals used to satisfy carved-out production payments would be deductible when incurred. Thus, the use of a carved-out production payment would not cause income to be accelerated, and there would be, thus, no avoidance of the limitation on the percentage depletion deduction.

This treatment is not to apply to a production payment carved out for exploration or development of a mineral property if, under existing law, gross income is not realized by the person creating the production payment. For example, under existing law if A, the owner of a lease, carves out a production payment in favor of X in consideration of the drilling by X of a well on the lease owned by A, gross income is not realized by A on this transaction and A is not entitled, of course, to deduct the drilling costs incurred by X. Similarly, if A carves out a production payment for $100,000 and sells it to X for $90,000 and agrees to use the proceeds in drilling development wells on the lease to which the carve out relates, the $90,000 is not income to A under existing law and A cannot, of course, deduct the $90,000 spent in drilling the development wells. Thus, the bill would not treat the production payment as a loan in the case of either of the above examples, and in each case the production payment held by X would continue to be treated as an economic interest in his hands.

In the case of retained production payments (that is, the sale of mineral property subject to a production payment), the bill provides that the production payment is to be treated as a purchase money mortgage loan (rather than as an economic interest in the mineral property). Accordingly, the income derived from the property which is used to satisfy the payment would be taxable to the owner of the mineral property, subject, of course, to the allowance for depletion. In addition, the production costs attributable to producing the minerals used to satisfy the production payment would be deductible by the owner of the working interest in the year incurred. Thus, the owner of the working interest would be placed in essentially the same position as persons in other industries who purchase business assets subject to a mortgage.

Where, in a lease of mineral property, a production payment is retained by the lessor, the bill provides that the payment is to be treated, insofar as the lessee is concerned, as if it were a bonus granted by the lessee to the lessor which is payable in installments. In other words, the lessee is to be required to capitalize the payments and then recover it through depletion. In the hands of the lessor, however, the production payment is to be treated in the same manner as under present law (that is, as derived from an economic interest in the mineral property and thus includible in income subject to the deduction for percentage depletion).

It is contemplated that the regulations issued on this provision will make it clear that on a sale or other disposition (including an abandonment) of a mineral property burdened by a production payment carved out by the taxpayer, any unpaid balance of the production payment will be taken into account in computing the gain or loss on the sale or other disposition.

Effective date.—Under the House bill, this provision was to apply with respect to mineral-production payments created on or after April 22, 1969, other than production payments created prior to January 1, 1971, pursuant to a binding contract entered into before April 22, 1969. The committee amendments change the April 22, 1969, dates to October 9, 1969. Accordingly, this provision is to apply to production payments created on or after October 9, 1969, other than production payments created prior to January 1, 1971, pursuant to a binding contract entered into before October 9, 1969.

The committee amendments also include two transitional rules. Under the first transition rule, a taxpayer is to be allowed to elect (at the time and in the manner prescribed by the Secretary of the Treasury or his delegate by regulations) to treat carved-out production payments which were sold during and after the taxpayer's last taxable year ending prior to October 9, 1969, in the manner prescribed by the bill; that is, the taxpayer may elect to treat these payments as loans rather than as sales. Since productions payments created in the taxpayer's preceding taxable year can result in net operating losses in the current taxable year, this provision, in effect, will allow taxpayers to undo net operating losses they had previously created. Any refund of a prior year's taxes which a taxpayer becomes entitled to by reason of this election is to be made without interest.

The second transitional rule provided by the committee amendment provides in effect that the new rules contained in this provision are not to apply to carved-out production payments sold during that part of the taxpayer's taxable year which occurs after October 8, 1969, to the extent the production payments offset a net operating loss which would otherwise occur in the taxable year in the absence of the carve-outs.

Specifically, it is provided that the new rules are not to apply to carved-out production payments sold during the post-October 8 part of the taxpayer's taxable year to the extent the production payments are necessary to increase the taxpayer's gross income for the year to the amount of the taxpayer's deductions (other than the net operating loss deduction) for the year. The amount of carved-out production payments qualifying for this treatment, however, when added to the amount of carved-out payments sold by the taxpayer during the pre-October 9 part of his taxable year may not exceed the amount of carved-out production payments sold by him during his preceding taxable year (i.e., during his last taxable year ending before October 9, 1969). This treatment is not to be available for purposes of the percentage depletion provisions of the code or the limitations on the foreign tax credit. The House bill contained a similar transition rule which made the new rules inapplicable (other than for percentage depletion and foreign tax credit limitation purposes) to carved-out production payments sold during the part of a taxpayer's taxable year occurring on or after the effective date of this provision, to the extent the payments did not exceed the intangible drilling costs, exploration expenditures, and development expenditures incurred by the taxpayer during the part of his taxable year prior to the effective date.

Revenue effect.—It is estimated that this provision will result in an annual revenue increase of $100 million in 1970, $150 million in 1974, and $200 million when fully effective.

6. Mining Exploration Expenditures (sec. 506 of the bill and secs. 615 and 617 of the code).

Present law.—Under present law, a taxpayer may elect to deduct, without dollar limitation, in computing taxable income, mining exploration expenditures (that is, expenditures for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or any mineral other than oil or gas) which are paid prior to the beginning of the development stage of the mine. This deduction is only allowed, however, with respect to mines located in the United States or on the Outer Continental Shelf. When a mine reaches the producing stage, there is a recapture of the exploration expenditures previously deducted. This recapture is accomplished by disallowing the depletion deduction with respect to the mine to the extent of the previous deductions for exploration expenditures; that is, until the amount of depletion disallowed equals the exploration expenditures previously deducted. A taxpayer may avoid this form of recapture by electing, when the mine reaches the producing stage, to include in income the amounts previously deducted as exploration expenditures. Provision is also made for the recapture of the previous exploration deduction where the mining property is disposed of prior to the time when there has been a complete recapture through the disallowance of depletion.

A taxpayer who does not elect the unlimited deduction for mining exploration expenditures described above may elect to deduct a limited amount of exploration expenditures, whether on domestic or foreign mines, without the recapture rules applying. The total of the deductions allowed to any one taxpayer under this limited rule is $100,000 a year, but for all taxable years the total may not exceed $400,000. A taxpayer in this case can both write off the exploration expenditures currently and then, in addition, receive the full amount of depletion when the mine reaches the producing stage, or receive capital gains treatment on the entire amount of the gain upon a sale of the mining property.

General reasons for change.—The committee recognizes that the allowance of a current deduction for mining exploration expenditures provides an incentive for hard mineral explorations. The committee agrees with the House that it is not necessary, however, to allow both the current deduction of exploration expenditures and also depletion with respect to production to provide the desired incentive. The general rule of present law which allows an unlimited deduction for mining exploration expenditures, but which provides for the subsequent recapture of those deductions—which it is believed most producers use—is based on this principle. It is difficult for the committee to find any basis for having the exception in present law which allows taxpayers to elect a current deduction of mining exploration expenditures (up to $400,000) with no subsequent recapture.

The treatment of expenditures which are incurred during the development or producing stage of a mine also is of concern to the committee. As indicated above, under present law, mineral exploration expenditures are currently deductible but subject to recapture, if they are incurred prior to the development stage of a mine. Expenditures incurred after the development stage of a mine has been reached also are currently deductible, either as development expenditures or operating expenses, but are not subject to recapture. It appears clear to the committee that Congress in enacting these provisions of law intended that exploration type expenditures during the development or producing stage of a mine would be treated as deductible development expenditures or operating expenses (except where the expenditures were made to discover a new mine), rather than as exploration expenditures. The Revenue Service, however, apparently supported by one circuit court case (*Santa Fe Pacific Railroad Co.* v. *United States*. 378 F. 2d 72 (7th Cir.)), has at times taken the view that these expenditures are not to be treated as development or operating expenses, but rather are to be considered exploration expenditures which must be capitalized since they are incurred after the development stage of the mine has been reached.

The committee believes that Congress intended to allow the deduction of *all* expenditures incurred by a taxpayer in bringing a mine into production, either as exploration expenditures during the exploration stage or as development expenditures or operating expenses during the development and production stages. In other words, under present law and under the revisions of present law contained in the committee amendments, expenditures on a mine after the development stage has been reached are to be treated as deductible development expenditures or operating expenses, unless the expenditures are made for the purpose of discovering a new mine. That is, if a mine is in the development or production stage, exploratory expenditures (drilling, crosscutting, etc.) to determine the location, extent, or quality of a known deposit in the mine, or to locate or find other veins of ore in the mine, are deductible without recapture. However, if the exploration project is for the discovery of a new mine, even though conducted from underground workings of an existing mine, the expenditures would be subject to section 617. For example, if the operator of an existing mine enters into an agreement with the owner of adjacent land to drive crosscuts from the bottom of the existing mine into the adjacent lands to find out whether there are deposits of ore which would "make a mine," the exploration expenditures would be subject to section 617 even though the agreement provides that the operator of the existing mine, if the exploration project is successful, will have a share in the new mine when it is developed.

Explanation of provision.—For the reasons discussed above, both versions of the bill provide that all mining exploration expenditures made after the effective date of this provision (July 22, 1969, under the House bill and December 31, 1969, under the committee amendments) are to be subject to the general recapture rules of present law.

In addition, it is provided that taxpayers may continue to deduct expenditures for foreign (and oceanographic) explorations to the extent permitted under present law. Thus, taxpayers generally may deduct expenditures for foreign explorations to the extent these expenditures do not exceed $400,000, reduced by the aggregate of any amounts (whether for foreign or domestic exploration) previously deducted or deferred under the exploration expense provisions of present law (either the limited or the general deduction). In addition, a taxpayer who elects for the first time to claim a current deduction for mining exploration expenditures would be allowed to deduct expenditures for foreign explorations under the general deduction rule, subject to its recapture provisions, until the taxpayer's total deductions for mining exploration expenditures (whether domestic or foreign) equals $400,000.

Under the bill, mining exploration expenditures made prior to the effective date of this provision which were deducted under the provision of present law limiting the total deduction for exploration expenditures to a maximum of $400,000 are not to be subject to recapture.

The committee amendments also provide that taxpayers who have elected to deduct mining exploration expenditures under the provision of present law which limits the total deduction to $400,000 are to be deemed (unless they notify the Secretary of the Treasury or his delegate to the contrary) to have made an election to deduct exploration expenditures under the general provision, insofar as expenditures made after December 31, 1969, are concerned. This is the result which the committee believes was intended by the House.

In essence, the bill extends to all mining exploration expenditures the concept that a taxpayer in the hard mineral industry should not be allowed to benefit from both a current deduction for exploration expenditures, and, in addition, depletion on the property when it reaches the producing stage or capital gains treatment with respect to the property if it is sold. At the same time the bill continues the present privilege which taxpayers have of deducting exploration expenditures for foreign (and oceanographic) explorations up to the point where their exploration expenditure deductions total $400,000.

Effective date.—Under the House bill, the changes made by this provision were to apply with respect to mining exploration expenditures made after July 22, 1969. The committee amendments provide that the changes made by this provision are to apply with respect to exploration expenditures made after December 31, 1969.

7. Continental Shelf Areas (sec. 507 of the bill and sec. 638 of the code)

Present law.—Present law is not explicit as to whether for purposes of the exploration for, or exploitation of, natural resources in the continental shelf area of a country over which the country exercises tax jurisdiction under the principles of international law, that area is considered for U.S. tax purposes as a part of the country.

General reasons for change.—The development of natural resources in the continental shelf areas of the world makes the status of these areas for tax purposes of increasing importance. This status is important, for example, in determining the source of income from mining activities conducted in continental shelf areas and in the application of the foreign tax credit with respect to this income. Accordingly, the committee believes it appropriate to clarify the status of continental shelf areas with regard to the application of the income tax provisions of the code to natural resource activity.

Explanation of provision.—The committee has added an amendment to the House bill to provide that for purposes of applying the income and employment tax provisions of the code (including those relating to the source of income from personal services) with respect to mines, oil and gas wells and other natural deposits, the term "United States" when used in a geographical sense includes the seabed and subsoil of the submarine areas adjacent to the territorial waters of the United States over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources.

The committee amendments also add a cross-reference to the provisions of the Code dealing with withholding of tax on payments to nonresident aliens which makes it clear that wages or salaries received for personal services performed on a mine or oil or gas well located or being developed on the Continental Shelf of the United States constitute income from sources within the United States.

The committee amendments also provide that the term "foreign country" (or possession) when used in a geographical sense includes the seabed and subsoil of the submarine areas adjacent to the country (or possession) over which the government of the country (or the U.S. Government in the case of a possession) has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. In the case of a foreign country, this rule applies only if the government of the country exercises, directly or indirectly, taxing jurisdiction with respect to the exploitation of the natural resources. The bill makes it clear, however, that a foreign country is not to be treated as contiguous to the United States by reason of these definitions.

Q. CAPITAL GAINS AND LOSSES

1. Alternative Tax Rate For Individuals (sec. 511 of the bill and sec. 1201 of the code)

Present law.—Under present law, one-half of an individual's net long-term capital gains are included in taxable income and, accordingly, are taxed at the regular tax rates. Thus, an individual's long-term capital gains usually are subject to tax at a rate which is one-half his marginal tax rate. Where, however, an individual's marginal tax rate is over 50 percent and thus where his long-term capital gains would be subject to a tax rate of over 25 percent—the marginal tax rate applied to one-half of the gains—the long-term gains instead are taxed at the alternative capital gains rate of 25 percent. In other words, the tax rate on long-term capital gains is 25 percent for married couples filing a joint return when their taxable income (including the half of capital gains which is includible in income) is greater than $52,000 ($26,000 in the case of the single persons). This same 25-percent tax rate is applicable whether the couple's other taxable income is $53,000 or $1 million.

General reasons for change.—In recent years, many high-income taxpayers have taken advantage of the lower 25-percent alternative tax rate by revising their investment strategies to convert as much as possible of their income into capital gains. For these taxpayers, the alternative rate operates as an exclusion which varies with the taxpayer's marginal tax rate. For example, a taxpayer with a 70-percent marginal tax rate, in effect, includes only 36 percent of his net long-term capital gains in his income, or, in other words, he is permitted to deduct from income 64 percent of his capital gains. Taxpayers with 65-, 60-, and 55-percent marginal rates in effect include only 38, 42, and 45 percent, respectively, of their capital gains in income. As a result, the proportion of a taxpayer's capital gains income subject to tax varies according to his tax rate, so that the higher his tax rate, the smaller the portion of the gain that is taxed.

The alternative tax rate, thus, may be considered as being at variance with the intent of the progressive rate structure to tax individuals according to their ability to pay and as going beyond the fundamental purpose of the 50-percent inclusion provision of not taxing income accrued over several years as though it were earned in a single taxable year. The alternative tax operates to create a large difference between the tax rate paid on capital gains and that paid on ordinary income by taxpayers in higher tax brackets. Lower bracket taxpayers, on the other hand, who receive only ordinary income, or whose ordinary income and included capital gains are not large enough to qualify for the alternative rate, pay successively higher marginal tax rates on the proportion of their income that is subject to tax.

Table 14.—RETURNS WITH ALTERNATIVE CAPITAL GAINS TAX, 1969

AGI class	Number of returns	Percent of all returns in class using alternative tax	Percent of capital gains in class taxed at alternative rate	Capital gains taxed at alternative rate as a percent of AGI	Income tax liability for returns using alternative rate as a percent of AGI plus the excluded ½ of long-term gains
Under $20,000					
$20,000 to $50,000	23,000	0.9	2	3.8	30.4
$50,000 to $100,000	90,000	26.5	29	8.9	30.2
$100,000 to $200,000	46,000	63.0	75	20.9	31.6
$200,000 to $500,000	14,000	77.4	90	37.0	30.9
$500,000 to $1,000,000	2,000	70.2	94	50.7	29.9
$1,000,000 and over	1,000	85.2	95	61.4	28.5
Total	176,000	0.2	28	25.4	30.5

The alternative tax rate is used by a relatively small group of individual taxpayers. In 1969, as shown in the table above, 176,000 taxpayers, or approximately 2 percent of the total number of taxpayers reporting capital gains, were in a position to use the alternative rate. This group, however, accounted for approximately 28 percent of all capital gains reported by individual taxpayers.

Taxing capital gains at the alternative rate has the effect of significantly reducing the overall tax rate paid by higher income taxpayers. Individual taxpayers with adjusted gross incomes between $20,000 and $50,000 had includable capital gains which comprised 3.8 percent of their adjusted gross income. The percentage rose to 37 percent for those with adjusted gross incomes between $200,000 and $500,000 and to more than 61 percent for individuals in this group with adjusted gross incomes greater than $1 million. The table shown below indicates that the effective tax rate for these individuals decreases as their income level rises above $200,000 and is lower for taxpayers with adjusted gross incomes above $1 million (28.5 percent) than for taxpayers with adjusted gross incomes between $20,000 and $50,000 (30.4 percent).

In the absence of the alternative tax, the effective rate of tax paid by this group of taxpayers would be increased. The same table shows that the principal increases in effective tax rates would occur for taxpayers with adjusted gross incomes above $200,000, and the relative amount of increase in effective tax rates would be greater for high-income taxpayers. For example, at 1969 levels, the effective tax rates of taxpayers with adjusted gross incomes between $200,000 and $500,000 would be increased from 30.9 percent to 34.7 percent, an increase of 12 percent, and the effective tax rates for taxpayers with adjusted gross incomes greater than $1 million would be increased from 28.5 percent to 35.6 percent, an increase of 25 percent.

TABLE 15.—RETURNS WITH ALTERNATIVE CAPITAL GAINS TAX, ESTIMATED 1969

AGI class	Income tax liability as a percent of AGI plus the excluded one-half of long-term gains: Present law	Without the alternative rate (House bill)	Finance committee bill
Under $20,000			
$20,000 to $50,000	30.4	30.6	30.6
$50,000 to $100,000	30.2	30.5	30.4
$100,000 to $200,000	31.6	33.1	32.7
$200,000 to $500,000	30.9	34.7	34.4
$500,000 to $1,000,000	29.9	35.7	35.5
$1,000,000 and over	28.5	35.6	35.5
Total	30.5	33.2	32.9

The committee agrees with the House that it is not appropriate for high income taxpayers to substantially reduce their effective rate of tax by means of the alternative capital gains tax. This is at variance with the intent of the progressive tax rate structure and, in addition, causes effective tax rates to level off and then start to decline for taxpayers with income levels above $200,000. The committee's amendments are in accord with the objectives of the House bill. However, it was thought that taxpayers with relatively small amounts of capital gains and nominal amounts ($10,000 or less) from tax preference sources other than capital gains should continue to be eligible for the 25 percent alternative tax (plus applicable surcharge). As is indicated in the above table, this has relatively little effect on the effective rates which would result under the House bill for those with adjusted gross incomes in excess of $200,000.

Explanation of provision.—The committee modified the House provision which would have repealed the alternative capital gains tax for individuals. The committee amendments continue the availability of the alternative tax for the excess of net long-term capital gains over net short-term capital gains up to $140,000 of gains per return ($70,000 for married persons filing separate returns) in those cases where the taxpayer does not receive other preference income that exceeds $10,000. Net long-term capital gains above the $140,000 level are to be taxed in the same manner as other capital gains, i.e., one half is included in ordinary income and taxed at progressive income tax rates.

does not exceed $10,000, will determine his tax liability by making income in excess of $140,000, but where other tax preference income

A taxpayer who has ordinary income and net long-term capital gains three tax computations. First, he will determine his tax on his ordinary income. Then, he will determine his tax on the first $140,000 of capital gains, which is 25 percent of this amount. Finally, to determine his tax on his capital gains over $140,000 he will have to, in effect, determine what his tax would be on these gains if one-half of them were added on top of ordinary income and one-half of the $140,000.[1]

The committee also modified the House provision by providing a gradual phaseout of the alternative tax on net long-term capital gains in excess of net short-term capital losses that are more than $140,000. The gradual upward transition in this phaseout is designed to avoid significant disturbances in the timing of capital transactions which could occur by virtue of an increase from the present 27.5 percent (25% alternative tax plus 10 percent surcharge) ultimately to 32.5 percent (65 percent maximum rate applied to one-half of capital gain). Without this gradual transition the capital gains rates would first rise above this level to 35.875 percent in 1970 and then again decline to the 32.5 percent in 1972 (see tabulation below). Such variations in rates appear to be too great a tax increase for a seller who is anticipating capital gains income from a sale to accept with equanimity. The phaseout of the alternative rate avoids these results by providing a gradual upward transition in the maximum effective rate on capital gains not eligible for the 25 percent alternative tax to 29.5 percent in 1970, 31.0 percent in 1971 and, finally, 32.5 percent in 1972 and thereafter. A comparison of these rates and the rates which would otherwise apply are shown in the tabulation set out below:

COMPARISON OF MAXIMUM TAX ON NET LONG-TERM CAPITAL GAINS INCOME

Year	Present law	With phaseout of alternative tax	Without phaseout of alternative tax
1969	[1] 27.5	[1] 27.5	[1] 27.5
1970	[2] 25.625	[2] 29.5	[2] 35.875
1971	25.0	31.0	34.0
1972	25.0	32.5	32.5

[1] Includes 10 percent surtax.
[2] Includes 5 percent surtax through June 30, 1970.

Two other transitional rules also were adopted. The first of these relates to sales or dispositions under binding contracts that were in effect on October 9, 1969. They are excepted from the provision generally repealing the alternative capital gains tax on gains over $140,000. They will continue to be taxed at 25 percent, plus any applicable surcharge. This is true even though these sales are consummated at a later date. It is also true with respect to installment sale payments received after the effective date of the change on sales on or before October 9, 1969, or pursuant to binding contracts in effect on that date. The binding contract rule is not to apply, however, in the case of gains from timber, coal, or domestic iron ore which are taxed as capital gains (under sec. 631) or in the case of patents (taxed under sec. 1235). Under this

[1] This requires a tentative tax computation first on ordinary income plus one-half of $140,000 of capital gains. Second, a tentative tax would be computed based on total income including one-half of all capital gains. The difference between these two amounts is his tax liability on these capital gains over $140,000.

provision, stock market orders to sell at market placed on or before October 9, 1969, but not executed until after that date, are to be treated as binding contracts.

Second, the committee amendments provide that liquidating distributions made by a corporation prior to October 10, 1970, made under a plan of complete liquidation adopted prior to October 10, 1969, are to continue to be eligible for the 25 percent alternative tax plus any applicable surcharge.

To the extent the $140,000 of capital gains subject to the 25 percent alternative tax is used up by gains qualifying under one or more of the two rules discussed above, the 25 percent alternative tax is not to be available for other gains.

Effective date.—Specific alternative rates are provided for calendar years 1970, 1971 and 1972 and subsequent years. The House bill was effective for sales or other dispositions made after July 25, 1969.

Revenue effect.—It is estimated that this provision will increase revenues by $330 million when fully effective in 1972.

2. Alternative Tax Rate for Corporations (sec. 511 of the bill and sec. 1201 of the code)

Present law.—A taxpayer other than a corporation is allowed to deduct from his adjusted gross income 50 percent of the excess of net long-term capital gains over net short-term capital losses. The effect of this deduction is generally similar to a tax on such income at one-half the taxpayer's marginal rate bracket. A taxpayer who is above the 50-percent marginal tax bracket (or whose included half of net capital gain, when added to his other income, would put him above that bracket) may use the "alternative tax," which taxes the entire excess net long-term capital gain at 25 percent. This, in effect, limits the amount of tax any individual will have to pay on his excess of net long-term capital gains over his short-term capital losses.

Corporations are not allowed the 50-percent deduction for the excess of their net long-term capital gains over net short-term capital losses. Instead, they are permitted to use the 25-percent alternative tax. The corporate tax structure is not graduated (as in the case for individuals) but is computed on the basis of a normal tax of 22 percent of taxable income and a surtax of 26 percent of that part of the taxable income which exceeds $25,000. Usually only those corporations with taxable incomes in excess of $25,000 (on which the tax rate would be 48 percent, apart from the effect of the surcharge) use the alternative tax.

General reasons for change.— As indicated above in the discussion on the alternative capital gain tax for individuals, the committee generally agrees with the House bill eliminating the alternative tax for individuals. The effect of this is ultimately to raise the maximum capital gain rates for individuals to 32.5 percent.

The committee agrees with the House that a comparable adjustment should also be made to the corporate alternative tax. In addition, as a realistic matter, a corporation's capital gains are more in the nature of business income which is not essentially different from its other income. Since corporations are subject to only a one-step graduation at $25,000 (individuals' incomes, in contrast, are subject to 25 steps of graduation, with the top bracket not reached until $200,000 ($400,000 in the case of joint returns)), corporations usually are not subject to the problems of having bunched income taxed at steeply graduated rates. Accordingly, the committee believes it is appropriate to raise the corporate alternative tax to a greater percentage of the regular corporate tax rate.

Explanation of provision.—Both the House bill and the committee amendments raise the alternative capital gains tax rate for corporations, applicable to the excess of net long-term capital gains over net short-term capital losses, from 25 to 30 percent. However, those corporations with taxable incomes of less than $25,000 (including capital gains) will still pay a tax at the rate of 22 percent (the normal tax rate applied to all corporate taxable income under $25,000) on such capital gains.

The committee advanced the effective date of this change to December 31, 1969 (from July 31, 1969 in the House bill), and provided a phase-in of the new rate over a 2-year period. The rate for 1969 is to remain at 25 percent (with the surcharge, the rate for 1969 will be 27.5 percent), and the rates applicable during the phase-in are to be 28 percent (excluding the surcharge) in 1970 and the full 30 percent in 1971. In the case of a taxable year which is a fiscal year beginning in 1969 and ending in 1970, or beginning in 1970 and ending in 1971, the alternative tax would be prorated (in accordance with the rules of sec. 21, dealing with changes in rates during a taxable year).

The committee also provided the same two transitional provisions for corporations as for individuals. First, the committee amendments provide that capital gains arising from sales or other dispositions under binding contracts that were in effect on October 9, 1969, are to be taxed at 25 percent, plus any applicable surcharge. This provision applies with respect to installment payments received after the effective date, pursuant to sales on or prior to October 9, 1969, or pursuant to binding contracts in effect on that date. This binding contract rule is not to apply, however, in the case of gain from the cutting or sale of timber or coal or domestic iron ore royalties (taxed as capital gains under sec. 631) or to amounts received from patents which are given capital gains treatment (under sec. 1235).

Second, the committee amendments provide that liquidating distributions made by a corporation before October 10, 1970, made under a plan of complete liquidation adopted prior to October 10, 1969, are to continue to be eligible for the 25 percent alternative tax plus any applicable surcharge.

Effective date.—Specific alternative tax rates are provided for calendar years 1970 and 1971 and subsequent years. The House bill was effective with respect to sales or other dispositions made after July 31, 1969.

Revenue effect.—It is anticipated that this provision will result in a revenue gain of $140 million in 1970 and an annual gain of $175 million thereafter.

3. Capital Losses of Individuals (sec. 513 of the bill and secs. 1211(b), 1212(b), and 1222(9) of the code)

Present law.—Under present law, both individual and corporate taxpayers may deduct capital losses to the extent of their capital gains. In addition, if an individual's capital losses exceed his capital gains, he may deduct up to $1,000 of the excess loss against his ordinary income.

On the other hand, where an individual has a net long-term capital gain rather than a net capital loss, a maximum of only one-half of the net long-term capital gain is subject to tax.

If a husband and wife each have capital transactions and a joint return is filed, their respective gains and losses are treated as though they have been realized by only one taxpayer and are offset against each other. Only $1,000 may be deducted against ordinary income. On the other hand, when both spouses have net long-term capital losses and file separate returns, each spouse is allowed to deduct up to $1,000 of net capital losses from ordinary income. Thus, by filing separately, a married couple may under some circumstances receive a total capital loss deduction against ordinary income of $2,000.

General reasons for change.— The present treatment of long-term capital losses is inconsistent in the case of individuals with the treatment of their long-term capital gains. Although a maximum of 50 cents of each $1 of long-term capital gains is subject to ordinary tax, when capital losses exceed capital gains, the excess loss is deductible dollar-for-dollar against ordinary income (up to a maximum of $1,000).

The committee also does not believe that married couples should be treated as one taxpayer for most purposes but, when it is more advantageous to them, should be treated as two separate taxpayers so that each spouse is allowed to deduct up to $1,000 of capital losses from ordinary income. The present treatment of losses also can provide persons living in community property States with an advantage over those living in noncommunity property States. Spouses living in noncommunity property States must have separate losses in order to claim them on separate returns and be eligible for the double deduction. Thus, they must either sell assets held in joint tenancy or each must sell his own assets. Moreover, unless husbands and wives in noncommunity property States have approximately equal incomes, they may lose more from filing separate returns than they gain from the additional $1,000 capital loss deduction. This is not true, however, in community property States where the community income is divided between the spouses. Moreover, in community property states, husbands and wives filing separate returns are automatically eligible for the benefit of the double deduction since gains and losses from community property are attributable in equal amounts to each of the spouses by operation of community property law.

Explanation of provision.—For the reasons discussed above, both the House bill and the committee amendments make two changes in present law. First, they provide that only 50 percent of net long-term capital losses in excess of net short-term capital gains may be deducted from ordinary income. The $1,000 limitation on the amount of capital losses which may be deducted from ordinary income is to continue to apply. However, $2,000 of long-term capital losses will be required to offset the $1,000 of ordinary income.

Second, both versions of the bill provide that the deduction of capital losses against ordinary income for married persons filing separate returns is to be limited to $500 for each spouse (in place of the $1,000 allowed under present law).

The limitation on the deduction of net long-term capital losses provided by the bill may be illustrated in the following manner as it applies to a married couple filing a joint return. For any year beginning after the effective date of the committee amendments, if the excess of the taxpayer's net long-term capital losses over his net short-term capital gains for the current year is $2,000 or less, then only 50 percent of the excess is to be deductible in the current year, and no amount of the loss would remain to be carried over in future years. If the excess of the taxpayer's net long-term capital loss over his net short-term capital gain in the current year is in excess of $2,000, he is to be allowed to deduct $1,000 of the excess from his ordinary income for the current year, and the portion of the excess over $2,000 could be carried over to a succeeding year and treated as a long-term capital loss in that year.

Capital losses arising in taxable years prior to the effective date of the committee's amendments would continue to be treated under existing law. Net short-term capital losses are to continue to be deductible in full against ordinary income subject to the $1,000 limit. Also, these amendments do not affect the treatment of capital losses of corporate taxpayers, since corporations are not allowed to deduct capital losses from ordinary income.

Effective date.—The committee amendments are effective for taxable years beginning after December 31, 1969. The amendments made by the House bill would have been applicable with respect to taxable years beginning after July 25, 1969.

Revenue effect.—It is estimated that this provision will result in an annual revenue increase of $50 million in 1970, $60 million in 1974, and $65 million in the long run.

4. Capital Loss Carrybacks For Corporations (sec. 512 of the bill and secs. 1212(a)(1), 381(b)(3), 6411, 6501, 6511(d), 6601(e), and 6611(f) of the code)

Present law.—Under present law, both corporations and individuals may carry net operating losses back 3 years and forward 5 years. In the case of capital losses, however, an unlimited loss carryover is available for individuals and a 5-year capital loss carryover is available for corporations. No carryback of capital losses is available either for individuals or for corporations.

Capital losses which presently may be carried forward to other years are first offset against capital gains realized in those years. Any losses remaining after this offset may, in the case of individuals, be offset against ordinary income generally to the extent of $1,000 a year. In the case of corporations, however, capital losses may only be offset against capital gains.

General reasons for change.—Congress in the past has found that a carryback of a net operating loss was often more beneficial to a corporation than a carryforward. A carryback frequently results in an almost immediate refund of tax paid in prior years, whereas a carryforward of a loss merely offers the prospect of a lesser tax at some time in the future. Therefore, when the carryback provision is used, money is made available at a time which is closer to the time when the loss occurred, and this often helps to provide relief for a taxpayer from the consequences of having incurred the loss. A similar situation exists in the case of capital losses for corporations. The committee sees no reason why capital losses should be treated any differently in this respect in the case of corporations than net operating losses. In the case of individuals, however, the problem is different because the loss in part is allowed against ordinary income.

Explanation of provision.—The committee amendments provide a 3-year capital loss carryback for a net capital loss of a corporation for any taxable year. This carryback provision is not available for foreign expropriation capital losses for which a special 10-year carryforward (in lieu of the regular 5-year carryforward) is available under present law.

This provision also is not available for a net capital loss arising in a year for which a corporation is treated as a Subchapter S corporation (i.e., a small business corporation under section 1372), nor can a net capital loss of a corporation be carried back to a taxable year for which the corporation was treated as a Subchapter S corporation. If any of a corporation's three years immediately preceding the current year were years for which it was treated as a Subchapter S corporation, then the number of years for which a carryback is available is reduced by that number. For example, if a corporation was treated as a Subchapter S corporation in 1973 but not in 1972 or 1974, and if it sustained a capital loss in 1975, then it could carry the loss back to 1972 and 1974, but not to 1973.

A rule (sec. 381(b)(3)) which presently applies with respect to the carryback of a net operating loss generally in the case of tax-free corporate acquisitions, is applied by the committee amendments to the carryback of a net capital loss. Under this rule, a corporation acquiring property in a distribution (or transfer) of the type specified, is not to be able to carry back a net capital loss for a year ending after the date of distribution (or transfer) to a taxable year of the distributor (or transferor) corporation. Such a post-acquisition net capital loss, however, could be carried back by the acquiring corporation to its own preacquisition taxable years.

Present law provides that taxpayers filing for refunds with respect to net operating loss carrybacks may obtain so-called "quickie" refunds. Under this procedure, the refund is made to them after only a preliminary check by the Internal Revenue Service on the appropriateness of the refund. (Subsequently a full examination is made by the Service of the refund under its regular auditing procedure.) Thus, the "quickie" refund is permitted before review by the Joint Committee on Internal Revenue Taxation of the refund, but a subsequent review is made in the same manner as in the case of other refunds of over $100,000. The committee amendments apply this same "quickie" refund procedure in the case of the 3-year capital loss carrybacks as presently is available in the case of net operating loss carrybacks.

There is no comparable provision in the House bill.

Effective date.—This amendment applies to capital losses sustained in taxable years beginning after December 31, 1969.

5. Collections of Letters, Memorandums, etc. (sec. 514 of the bill and secs. 1221(3) and 1231(b)(1)(C) of the code)

Present law.—Under present law, copyrights and literary, musical or artistic compositions (or similar property) are excluded from the definition of a capital asset, if they are held by the person whose efforts created the property (or by a person who acquired the property as a gift from the person who created it). Thus, gain arising from the sale of such a book, artistic work, or similar property is treated as ordinary income, rather than as capital gain. However, since collections of letters, memorandums, etc. (including those prepared by or for, directed to, or given to, the individual) are not specifically excluded from the definition of a capital asset, gains from the sale of such property are accorded capital gains treatment.

General reasons for change.—The rationale underlying the present law treatment of copyrights, artistic works, and similar property in the hands of the person who created them (or in the possession of a person who received the property as a gift from the person who created it) is that the holder of the property is, in effect, engaged in the business of creating and selling the artistic work or similar property (or is selling property created by the personal efforts of another who gave him the property). In view of this, gain arising from the sale of such property is treated as ordinary income derived as compensation for personal services rendered by the person (or the contributor), rather than as a capital gain from the sale of property held as a capital asset.

The committee believes that letters, memorandums, papers, etc. (or collections thereof) are essentially similar to a literary or artistic composition which is created by the personal effort of the taxpayer (or of the person who gave the property to the taxpayer), and should be classified in the same manner for purposes of the tax law. In the one case, a person who sells a book written by or for him is treated as receiving ordinary income for the product of personal efforts (i.e., compensation for personal services rendered). In another case, one who sells a letter or memorandum written by or for him is treated as receiving capital gain on the sale, even though the product he is selling is, in effect, the result of personal efforts.

Explanation of provision.—The bill provides that letters, memorandums, and similar property (or collections thereof) are not to be treated as capital assets, if they are held by a taxpayer whose personal efforts created the property or for whom the property was prepared or produced (or by a person who received the property as a gift from the person who created or prepared it). For this purpose, letters and memorandums addressed to an individual are considered as prepared for him. Gains from the sale of these letters and memorandums, accordingly, are to be treated as ordinary income, rather than as capital gains.

Since in the case of charitable contributions of ordinary income property the unrealized appreciation in the contribution has the effect of limiting the charitable contribution deduction under another provision in this bill to the cost or other basis of the property, the treatment of these letters, memorandums, etc., as giving rise to ordinary income will have an impact on the charitable contribution deduction available with respect to them under this other provision. The effect will be that, to the extent papers, memorandnms, etc., have no cost basis, no charitable contribution deduction will be available with respect to gifts of such property.

Effective date.—The amendments made by this provision are to be applicable with respect to sales and other dispositions occurring after December 31, 1968.

6. Holding Period of Capital Assets (sec. 1222 of the code)

Present law.—Capital gains on assets held longer than 6 months are considered long-term capital gains. In the case of individual taxpayers, 50 percent of the excess of net long-term capital gains over net short-term capital losses is included in income. In the case of corporations, the excess is taxed at a rate of 25 percent, rather than at the regular 48 percent corporate rate. Gains realized on the sale or exchange of capital assets held for not more than 6 months are considered as short-term capital gains, and generally they are fully taxable as ordinary income.

Problem.—The House felt that a better line of demarcation between gains for investment and speculative gains would be a 12-month holding period rather than the 6-month holding period of existing law. The committee, however, was concerned (as also was the Treasury Department) as to the impact this might have on the willingness of investors to take risks and, thus, on capital investments and on revenues.

Explanation of provision.—The House bill would have extended the holding period for long-term capital gains from 6 months to 12 months. The committee restored the 6-month holding period of present law.

7. Total Distributions From Qualified Pension, Etc., Plans (sec. 515 of the bill and secs. 402(a), 403(a)(2), and 72(n) of the code)

Present law.—Under present law, an employer who establishes a qualified employee pension, profit-sharing, stock bonus, or annuity plan is allowed to deduct contributions to the trust, or if annuities are purchased, may deduct the premiums. The employer contributions generally are not taxed to the employee until the amounts credited to his account are distributed or "made available" to him. In addition, income earned by the trust—or the earnings on reserves set aside by an insurance company for employee benefits—are exempt from tax if the employee trust is exempt (under sec. 501(a)).

On retirement, in the usual case the employee receives annual benefit payments which are taxed as ordinary income under the annuity rules (sec. 72) when the amounts are distributed, to the extent they do not represent a recovery of the amounts contributed by the employee. However, under an exception to this general rule, if the employee receives his benefits in a lump-sum distribution from the plan,[1] the payment is taxed as a long-term capital gain. Capital gains treatment is allowed only if the total distribution accrued to the employee's account is paid within 1 taxable year to the employee—or his beneficiary—on account of the employee's death, separation from the service of the employer, or the employee's death after retirement.

An employee who receives a lump-sum distribution of the type described above, which consists in whole or in part of securities of the employer corporation, also is not taxed at the time of distribution on the net unrealized appreciation in the securities (that is, the difference between the current value of the securities and the amount paid for

[1] Self-employed persons receiving "H.R. 10" plan distributions are taxed at ordinary income rates under a special 5-year averaging provision (sec. 72(n)(2)).

the securities by the qualified employee trust). Thus, an employee receiving employer securities is taxed only on the amount attributable to the employer's cost at the time of his contribution to the trust. This amount is taxed at capital gains rates. The unrealized appreciation is taxed as a capital gain at any future time when the stock is sold by the employee.

General reasons for change.—The capital gains treatment of lump-sum pension distributions was originally enacted in the Revenue Act of 1942 as a solution to the so-called bunched-income problem of receiving an amount in one year which had accrued over several years. As a means of achieving an "averaging" effect for these amounts received in one year, Congress provided capital gains treatment for these lump-sum distributions.

The capital gains treatment afforded these lump-sum distributions allows employees to receive substantial amounts of what is in reality deferred compensation at more favorable tax rates than other compensation received for services. In this regard, it appears that the more significant benefits accrue to taxpayers with adjusted gross incomes in excess of $50,000, and that a number of lump-sum distributions of over $800,000 have been made.

The manner in which the present treatment of qualified lump-sum pension distributions enable highly compensated employees to convert substantial amounts of compensation into capital gains may be illustrated by the following example: Assume a corporate executive who has had an average taxable income of $100,000 for the 4 years prior to a lump sum distribution; he receives a $500,000 (net of any employee contribution) lump-sum distribution after retiring; and he and his wife are expected to have taxable income of $35,000 for the next 5 years. Under present law, the taxpayer would pay an effective tax rate of 25 percent on the lump-sum distribution. On the other hand, if the distribution were treated as ordinary income and accorded general income averaging (under the present 133⅓ percent rules), the income received from the plan would be taxed at an effective rate of 66 percent. Alternatively, if he received the distribution pro rata over a 10-year period during his retirement and reported $50,000 a year as ordinary income (assuming a constant other taxable income of $35,000 each year), the effective tax rate on the total distribution would be 53 percent. In either of these cases, however, the effective rate is substantially above the 25 percent capital gains rate.

The committee therefore considers it appropriate to restrict the favorable capital gains treatment, as compared to pension income received over a period of years after retirement.

Explanation of provision.—Both the House bill and the committee amendments provide that the capital gains treatment (sec. 402(a)(2)) of lump-sum distributions received from qualified pension, profit-sharing, and stock bonus plans by the employee is to be limited to the portion of the distribution in excess of the contributions made by the employer. For this purpose, amounts contributed by the employer with respect to employees which are forfeited and then are reallocated among other employees are to be considered as contributions made by the employer. Presently, the taxable portion of the distribution is the total amount of the distribution less the employee's contribution.

Under both versions of the bill, an amount equal to the employer's contributions is to be accorded ordinary income treatment. The remainder of the distribution will receive capital gains treatment. Distributions under a qualified annuity plan are to receive similar treatment.

In both versions of the bill, however, the ordinary income treatment described above is not to apply to benefits accrued on behalf of the employee attributable to plan years beginning before January 1, 1970. Thus, the bill will continue the capital gains tax treatment for pension and profit-sharing benefits previously accrued by employees as well as for future earnings.

Both versions of the bill also provide that net unrealized appreciation in employer securities is to continue to receive deferred capital gains treatment until eventually sold by the employee. Here too, however, the amount of the total distribution representing the cost basis of employer contributions of employer securities in the plan is to be treated as ordinary income when received by the employee. This ordinary income treatment is not to apply, however, to employer contributions accrued on behalf of the employee attributable to plan years beginning before January 1, 1970.

The bill provides that the ordinary income portion of qualified lump-sum pension distributions is to be eligible for the tax treatment presently provided for lump-sum pension distributions to self-employed taxpayers under "H.R. 10" plans (sec. 72(n) (2)). This rule, in effect, is a special 5-year "forward" averaging method for the ordinary income part of a lump-sum distribution. It limits the tax liability on this portion to 5 times the increase in tax which would result from including 20 percent of the ordinary income portion of the net lump-sum distribution in gross income in the taxable year in which the total distribution is received. Employees (or their beneficiaries) are to be eligible for this special 5-year forward averaging method on the ordinary income amounts so distributed or paid on account of separation from service or death.[2] The special 5-year forward averaging method is not to be available to the employee unless he has been a participant in the plan for 5 or more taxable years before the taxable year in which the lump-sum distribution is made.

The committee amendments modify the 5-year averaging procedure of the House bill to eliminate the option to recompute the tax liability on the ordinary income amount after 5 years (determined by including one-fifth of this in gross income for each of the 5 years; the taxpayer would then be eligible for a refund if the recomputed tax were less than initially paid). Under the committee amendments, in place of this, employees may exclude from gross income for the computation of the tax liability on the ordinary income portion of the lump sum distribution the amount received during the year as compensation (other than as deferred compensation within the meaning of sec. 404) for personal services performed for the employer from whom he is receiving the lump-sum payment.[3] Also he may exclude the capital gain portion of the lump-sum distribution.

[2] Self-employed individuals, on the other hand, will continue to be eligible for the special 5-year averaging only on lump-sum distributions received on account of death, disability (as defined in sec. 72(m) (7)), or if received after the age of 59½.

[3] The exclusion of compensation from gross income for the tax computation, however, will not be available if the employee has not reached age 59½ years during the taxable year in which the distribution is received, unless he has died or become disabled (within the meaning of sec. 72(m) (7)).

This special averaging rule will prevent higher tax brackets from applying to the ordinary income amount of a lump-sum distribution merely because it is received in the final year of employment rather than the year following retirement when the taxpayer would not have this salary or wage income from the employer. Moreover, the exclusion of the capital gain portion from the tax computation base for the averaging of the ordinary income portion will also preclude a higher tax bracket during the taxable year of retirement due to the nonrecurring lump-sum distribution. Further, this special averaging rule obviates the need for a recomputation of tax liability after 5 years as well as the refund feature of the House bill, and this simplifies the computations involved for the taxpayer and enables him to determine the final tax liability on the lump-sum distribution for the taxable year when received.

Effective date.—These provisions are to be effective generally for taxable years ending after December 31, 1969. Specifically, the provisions are effective for employer contributions to qualified pension, profit-sharing, stock bonus, and annuity plans for plan years beginning after December 31, 1969 and to total distributions paid after December 31, 1969.

Revenue effect.—It is estimated that this provision will result in an annual revenue increase of $5 million in 1971 and $55 million in the long run.

8. Sales of Life Estates, etc. (sec. 516(a) of the bill and sec. 1001 of the code)

Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, bequest, or inheritance, a so-called "uniform basis" rule is applied with the basis of the property being divided between the life estate and the remainder. As the life estate is used up each year, its basis is reduced, and the basis of the remainder interest is increased in the same amount—hence, the combined basis of the life estate and the remainder interest remains the same from year to year.

The life tenant is not permitted to amortize his basis over the length of the life estate and thereby reduce for tax purposes the amount of income he receives. However, where the life tenant sells his right to receive future income, his basis in the property may be used to reduce the gain he receives on the sale.

The purchaser of the life estate, however, is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

General reasons for change.—The treatment described above has the effect of allowing a large part, and in some cases, almost all of income from a life estate or similar interest acquired by gift, bequest, or inheritance, to avoid taxation in those situations where the life tenant sells his interest. The life tenant is not taxed on the income to the extent of the basis which he is treated as having in the life estate when he sells it and, in addition, the purchaser of the life estate is not taxed on most of the income because he is allowed to reduce that income by amortizing his basis (his purchase price) in the life estate. In addition, in some cases the seller's basis has exceeded the amount he received upon its sale, and he has been permitted to take a deductible loss. The committee agrees with the House that income should not be allowed to completely escape taxation by this means.

Explanation of provision.—The House bill and the committee amendments, in effect, generally provide that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in a trust (which was acquired by gift, bequest, inheritance or a transfer in trust) is to be taxable, rather than only the excess of the amount received over the seller's basis for his interest.

Specifically, the bill provides that for purposes of determining the amount of gain or loss in such a case, any portion of a taxpayer's adjusted basis determined under the provisions dealing with the basis of property acquired by gift, from a decedent, or by a transfer in trust (secs. 1014 and 1015) is to be disregarded to the extent that the adjusted basis is a portion of the entire adjusted basis of the property. Thus, there is to be no basis to be offset against the proceeds received on a disposition of this type of interest, and, accordingly, the person disposing of the interest must treat the entire amount he receives from the disposition of his interest as a gain.

Neither version of the bill, however, changes present law in the situation where there is a sale or other disposition of a life (or term of years) interest in property (or an income interest in trust) as a part of a single transaction in which the entire interest in the property is transferred to another person or to two or more other persons jointly. Thus, for example, where a life tenant and remainderman hold all of the interests in property which they simultaneously sell in a single transaction, the transaction is to be treated in the same manner as under existing law; that is, the gain realized by the life tenant is to be measured by the excess of the proceeds received on the sale over his adjusted basis in the life estate. The committee agrees with the House that this exception is appropriate, since in this case the purchaser acquires a single entire interest in the property and, therefore, he is not allowed to amortize the separate life interest. Thus, he is taxed on the income from the property.

Effective date.—Under the committee amendments this provision is to be effective for sales or other dispositions after October 9, 1969. The House bill would have been effective with respect to sales or other dispositions made after July 25, 1969.

Revenue effect.—It is estimated that this provision will result in an annual revenue increase of $10 million.

9. Certain Casualty Losses Under Section 1231 (sec. 516(b) of the bill and sec. 1231(a) of the code)

Present law.—Generally, under present law (sec. 1231(a) of the code), if the gains on the disposition of certain types of property exceed the losses on this same type of property, in effect, the excess is treated as long-term capital gain. On the other hand, if the losses exceed the gains, then the net loss is treated as an ordinary loss. The long-term gains or losses generally taken into account for purposes of this computation of net capital gains or net ordinary losses include recognized gains or losses from:

1. sales or exchanges of depreciable property and real estate used in a trade or business; and

2. the compulsory or involuntary conversion of capital assets held for 6 months and depreciable property and real estate used in a trade or business.

Other gains taken into account for this computation include certain gains from timber, coal, iron ore, livestock, and unharvested crops.

The Technical Amendments Act of 1958 provided an exception to the rule described above. It provided that an uninsured loss on property (held for more than 6 months) resulting from fire, storm, shipwreck, or other casualty, or from theft, is not to be offset against gains treated as capital gains (that is, is not to be classified as a sec. 1231 loss) if the property was used in the taxpayer's trade or business (or was a capital asset held for the production of income). Thus, as a result of the 1958 amendment, these uninsured losses are deductible against ordinary income and are not required to be offset against gains which otherwise are treated as long-term capital gains. In other words, the 1958 amendment provided an exception to the general rule of section 1231 that the overall gain or loss position of the taxpayer under the section determines whether a loss is deductible against ordinary income or whether it must be used to offset what otherwise would be a capital gain.

General reasons for change.—The 1958 amendment was enacted to benefit business taxpayers who self-insure their business properties. Casualty losses on their business properties were excepted from section 1231 (and, thus, are fully deductible against ordinary income) in view of the fact that amounts added to their self-insurance reserves against casualty losses are not deductible although premiums paid to an outside insurance company for the same purpose by business taxpayers who are not self-insurers are deductible.

What may be considered somewhat anomalous results, however, have developed as a result of the 1958 amendment. On the one hand, a business taxpayer with a casualty loss on two similar business properties, one of which is insured and one of which is not, is allowed to deduct the loss on the uninsured property in full against ordinary income and at the same time is allowed to treat the gain on the insured property (the excess of the amount of insurance received over his adjusted basis in the property) as a capital gain. In other words, although this situation would appear to be squarely within the basic concept of section 1231 which requires losses to be netted against gains, such a netting is not required in this situation and, thus the loss rather than reducing the capital gain is deductible in full from ordinary income.

On the other hand, the basic offsetting of gains and losses is required where a business taxpayer only partially insures a business property. Thus, if a business taxpayer has a casualty loss on a business property which is only partially, perhaps 5 percent, insured, the deductibility of the loss against ordinary income is determined by the basic section 1231 rule which looks to the overall gain or loss position of the taxpayer. As indicated, however, if the property had not been insured at all, the loss would have been fully deductible against ordinary income without regard to the taxpayer's overall gain or loss position under section 1231.

The committee agrees with the House that the present distinction under section 1231 between insured and partially insured casualty losses is unrealistic. Moreover, the committee agrees that it is not appropriate to allow a business taxpayer to deduct an uninsured casualty loss on business property in full from ordinary income when he also has a larger casualty gain on insured business property which is treated as a capital gain.

Another problem which has arisen under section 1231 involves the basic scope of the section; namely, whether it is applicable to casualty losses on uninsured personal assets, such as a taxpayer's personal residence or nonbusiness automobile. The 1958 amendment does not apply if the destroyed property, whether or not completely uninsured, is a capital asset not held for the production of income or, in other words, a personal asset. In enacting this amendment, it appears Congress believed these uninsured casualty losses were subject to section 1231 and thus had to offset capital gains under the section, rather than being fully deductible against ordinary income. In initiating the 1958 amendment excluding uninsured casualty losses on business property from section 1231, this committee stated (S. Rept. 1983, 85th Cong., p. 204): "On the other hand, the amendment does not apply to loss arising from the destruction or theft of the taxpayer's uninsured personal automobile." This would indicate that it was felt such a loss was otherwise included under section 1231.

Section 1231, however, has been interpreted by some courts to mean that a casualty loss is not subject to the provisions of that section unless the taxpayer receives some property or money as compensation for the loss. (See, for example, *Maurer* v. *United States*, 284 F. 2d. 122, where the 10th Circuit Court of Appeals held in 1960 that an uninsured casualty loss in 1954 did not give rise to a sec. 1231 loss; however, the Internal Revenue Service has announced it will not follow the decision and several courts since 1960 have refused to follow the *Maurer* decision.) The effect of the *Maurer* decision line of reasoning is to treat uninsured losses with respect to a taxpayer's personal assets, such as his residence or nonbusiness automobile, as fully deductible against ordinary income, rather than being required to offset under section 1231 what otherwise would be long-term capital gains.

Explanation of provision.—The House bill and the committee amendments modify the treatment of casualty losses and casualty gains under section 1231 to meet the problems discussed above. Under the bill, casualty (or theft) losses on depreciable property and real estate used in a trade or business and on capital assets held for 6 months are to be consolidated with casualty (or theft) gains on this type of property. If the casualty losses exceed the casualty gains, the net loss, in effect, will be treated as an ordinary loss (without regard to section 1231). On the other hand, if the casualty gains equal or exceed the casualty losses, then the gains and losses will be treated as section 1231 gains and losses which must then be consolidated with other gains and losses under section 1231.

This consolidation rule is to apply whether the casualty property is uninsured, partially insured, or totally insured. In addition, it is to apply in the case of casualty property which is a capital asset held for 6 months whether the property is business property, property held for the production of income or a personal asset. (Although the House clearly intended to include personal capital assets within this consolidation rule, they were inadvertently omitted from the House bill. The committee amendments correct this omission.)

The bill also clarifies the fact that uninsured casualty losses on a taxpayer's personal assets, such as his personal residence or nonbusiness automobile, are subject to the basic section 1231 provisions.

Effective date.—The committee amendments provide that this provision is to be effective with respect to taxable years beginning after December 31, 1969. Under the House bill, this provision would have been effective with respect to taxable years beginning after July 25, 1969.

10. Transfers of Franchises, Trademarks, and Trade Names (sec. 516(c) of the bill and sec. 1252 of the code)

Present law.—Questions have arisen under present law concerning the proper tax treatment of the transferor and the transferee of a franchise. A similar situation exists in the case of transfers of trademarks and trade names.

It is difficult to resolve under present law whether the transfer of a franchise, trademark, or trade name is to be treated as a sale or as a license, and whether the transferors are selling franchises, trademarks, and trade names in the ordinary course of business. Depending upon how these questions are resolved, the transferor will receive ordinary income or capital gains treatment on the gain he realizes on the transfer. At present, these problems must be resolved under general tax principles, and this has produced differing results in the courts, despite factual similarities in the interests of the franchises, trademarks, or trade names transferred.

For a transaction to receive capital gains treatment, property which is transferred must generally constitute a capital asset and must be sold or exchanged. It has been frequently necessary for the courts to determine whether a variety of conditions included in the agreement between the transferor and the transferee transform a purported sale into a license, thus requiring the gains from the transaction to be taxed as ordinary income.

This question has resulted in a division of authority among the courts, some finding a sale and others a license. In either case, the decisions generally have been based on varying conditions in the transfer agreement and, when the agreement has been interpreted as reserving significant powers, rights, or continuing interests to the transferor, then it has been held that such reservations preclude a finding of a sale.

Frequently, payments made to the transferor by the transferee with respect to the transfer of a franchise, trademark, or trade name are payable over a period of time and are measured by a percentage of the selling price of the products sold or based on the units manufactured or sold, or any other similar method contingent upon production, sale or use. Some courts have treated this form of franchise transaction as if it were a license, with the result that the payments are taxable as ordinary income. Some other courts, however, have not regarded the form of payment to be controlling, with the result that all such payments have received capital gains treatment.

In addition to the problem of determining whether a transfer of a franchise, trademark, or trade name is actually a sale or exchange or merely a license, the question arises in the case of a sale or exchange whether the property transferred is a capital asset. Property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business is not considered a capital asset. Although the question whether transferors of franchises, trademarks, or trade names are in the business of selling this property has been raised (such as in the *Moberg* case in the Tax Court), it has not been fully explored or resolved by the courts.[1]

Under present law, amounts paid (initial fees or contingent payments) to acquire a franchise, trademark, or trade name may not be deducted by the transferee through depreciation or amortization, since franchises, trademarks, and trade names are considered to be intangible assets with unascertainable useful lives.

General reasons for change.—Since present law does not specifically deal with the transfer of a franchise, trademark, or trade name, and since there appears to be considerable diversity of opinion among courts as to whether such a transfer constitutes a license or a sale and whether part or all of the sale constitutes the sale of a capital asset, the committee agrees with the House that Congress should clarify these problems through legislation with regard to franchises. In addition, the committee believes this should encompass trademarks and trade names and also the treatment of transferees in these cases insofar as the deductibility of the payments they make to transferors is concerned.

Some transferors retain significant powers, rights, or continuing interests with respect to the subject matter of the franchise, trademark, or trade name. The committee believes that if the transferor exercises continuing, active, operational control of a franchise, trademark, or trade name, by retaining significant powers, rights or continuing interests, that this exercise of control is inconsistent with a sale or exchange of property.

In addition, some transferors participate so substantially in the day-to-day management of the transferee's business activities and operations that the transferor in effect has an operational interest in the transferee's business operations. For example, a transferor may participate in the business by conducting activities such as sales promotion (including advertising), sales and management training, employee training programs, holding of national meetings for transferees, providing the transferees with blue prints or formulae, and other forms of continuing assistance. The committee believes that any general control of the transferee's activities and operations by the transferor constitutes the retention of a significant power, right, or continuing interest.

Another aspect of this problem is the inability of the courts to agree on the proper treatment of the payments received where the transfer of a particular franchise, trademark, or trade name is considered a sale rather than a license. Amounts received by transferors from transferees are often indeterminate and may include a lump-sum payment or a fixed amount (including installment payments over a period of time) plus payments, contingent on future sales. It also would appear that the receipt of contingent payments could be viewed as constitut-

[1] The Tax Court has considered the issue on remand in *Vern C. Moberg*, 22 T.C.M. 1483 (1963)—from *Moberg* v. *Commissioner*, 305 F. 2d 800 (5th Cir. 1962); and *Dairy Queen of Okla., Inc.*, 18 T.C.M. 322 (1959)—from *Dairy Queen of Okla., Inc.*, v. *Commissioner*, 250 F. 2d 503 (10th Cir. 1957).

ing a continuing economic interest in the subject matter as well as being analogous to the receipt of royalty or rental income.

In many cases the question whether the transfer of a franchise, trademark, or trade name results in capital gain or ordinary income to the transferor could be resolved with reference to whether the property was held primarily for sale in the ordinary course of business.

The nature of some franchise, trademark, or trade name transactions support a determination that the property transferred by tranferors is property held primarily for sale in the ordinary course of business. For example, if property is held for only a short time before it is sold—which may not be unusual in some franchise operations—there is an indication that the property is held primarily for sale in the ordinary course of business (i.e., that it was acquired with an intention to sell it). It also may not be unusual for a franchisor to transfer as many as 15 or 20 or more subfranchises in the course of a given year, and although a number of sales of property in a given year does not necessarily place the seller in a business, a number of sales does suggest an intention to hold the property primarily for sale. In addition, it is not unusual for some franchisors to divide their territories into a number of smaller franchises for marketing purposes and to sell them to individual franchisees. As is the case in determining the status of a dealer in real estate (sec. 1237), the subdivision of property and its sale in a market which differs quantitatively from that in which it was purchased indicates an operation and sales activity consistent with holding the property primarily for sale in the ordinary course of business.

Explanation of provision.—Both versions of the bill provide rules regarding the tax treatment of transferors in the case of transfers of franchises. The committee amendments extend these rules to trademarks and trade names, and also provide rules regarding the tax treatment of transferees in these cases.

The committee amendments provide that the transfer of a franchise, trademark, or trade name is not to 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. Thus, a transferor is not to receive capital gains treatment in these cases. If the transfer agreement includes significant conditions or restrictions which are subject to the transferor's approval on a continuing basis, this power to exercise continuing, active, operational control over the transferee's business activities is to be considered as a retention by the transferor of a significant power, right, or continuing interest. Moreover, if the transferor's conduct constitutes participation in the commercial or economic activities of the transferee's business, then this also is to be regarded as a retention of a significant power, right, or continuing interest. These rules also were contained in the House bill, but only with respect to franchises.

Under the committee amendment the concept of a "significant power, right, or continuing interest" is to include, but is not to be limited to: (A) a right to disapprove any assignment or any part thereof; (B) a right to terminate at will; (C) a right to prescribe the standards of quality of products used or sold or of services furnished, and of the equipment and facilities used to promote such products or services; (D) a right to require that the transferee sell or advertise only products or services of the transferor; (E) a right to require that the transferee purchase substantially all of his supplies and equipment from the transferor; (F) and a right to payments contingent on the productivity, use or disposition of the subject matter if such payments constitute a substantial element under the transfer agreement. The House bill in effect only included factors (A) and (B) above in the concept of a significant power, right, or continuing interest.

In addition, the committee amendments (but not the House bill) provide that all amounts received or accrued by the tranferor on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name, which are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name transferred are to be treated as ordinary income. Contingent payments would include continuing payments (other than installment payments of a principal sum agreed upon in the transfer agreement) measured by a percentage of the selling price of products marketed or based on the units manufactured or sold, or any other similar method based upon production, sale or use, or disposition of the franchise, trademark, or trade name transferred.

The committee amendments also provide that amounts paid or incurred during the taxable year on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name which are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name transferred, are to be deductible by the transferee as trade or business expenses.

In addition, the committee amendments provide that the treatment of initial payments (including a lump-sum or fixed amount payable in installments) by a transferee of a franchise, trademark, or trade name to a transferor is to be determined by reference to whether the agreement constitutes a sale or a license. Where it is a sale, the committee intends that the transferee is to continue to be treated as under present law; that is, if he has purchased an intangible asset without an ascertainable useful life, he would not be entitled to deductions for the lump-sum payment or installment payments to the transferor. Of course, the franchise, trademark, or trade name may have an ascertainable life in the circumstances of a particular case.

Where, however, the agreement is not a sale under the committee amendments, then it is provided that the transferee may deduct the initial payments over the period of the agreement to which they are attributable but, in no event, over more than 10 taxable years. This treatment is to apply in these cases to any payment, other than a contingent payment, in discharge of a principal sum agreed upon in the transfer agreement. Thus, in the case of a single payment, the transferee is to be allowed to deduct the payment ratably over 10 years if the transfer agreement is for a period of more than 10 years, or ratably over the period of agreement, if not more than 10 years. If approximately equal payments in discharge of the principal sum are payable over the period of the transfer agreement (or a period of more than 10 taxable years, whether ending before or after the period of the transfer agreement), the payments may be deducted in the taxable year made. The Treasury is to provide consistent rules for the deduction of other methods of payment of the principal sum.

The committee amendments provide that in the case of transfers of franchises, trademarks, or trade names before the effective date of this provision, the transferee may elect to deduct payments which would be deductible under the new rules as if the transfer had occurred after the effective date of the provision. This is only to be available, however, with respect to payments made in taxable years ending after December 31, 1969, and only if the transaction were treated for tax purposes as a license rather than a sale from the transferor's standpoint.

For purposes of this provision, a transfer is to include a transfer of any interest (i.e., a part) in a franchise, trademark or trade name.

The committee amendments also provide that the term "franchise" includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area. This would include distributorships or other similar exclusive-type contract arrangements to operate or conduct a trade or business within a specified area, such as a geographical area to which the business activity of the transferee is limited by the agreement. However, the committee amendments provide that the new rules are not to apply to the transfer of a franchise to engage in a professional sport. This exception applies only to franchises for teams to participate in a professional sports league, and would not apply to other franchised sports enterprises, such as a franchise to operate a golfing, bowling, or other sporting enterprise as a trade or business. The House bill did not define "franchise" in detail, but would have applied to professional sport franchises.

The term "trademark," as defined in section 45 of the Trademark Act of 1946 "includes any word, name, symbol, or device or any combination thereof adopted and used by a manufacturer or merchant to identify his goods and distinguish them from those manufactured or sold by others." The term "trade name" under this provision would include a trade brand.

Effective date.—The amendments made by this provision of the committee amendments are to apply to transfers after December 31, 1969.

Under the committee's amendments, all renewals of existing franchise, trademark, or trade name agreements after the effective date of this provision are to be regarded as a transfer of a franchise, trademark or trade name.

R. REAL ESTATE DEPRECIATION

(Sec. 521 of the bill and secs. 167 and 1250 of the code)

Present law.—Present law (since 1954) provides that new real property may be depreciated in the same manner as new tangible personal property, so that when a building is first placed in service the double-declining-balance method or the sum-of-the-years-digits method may be used by the first owner. (These methods generally permit large portions of an asset's total basis to be deducted in the first few years of the asset's useful life.) A later owner is permitted to use the 150-percent declining balance method, which is significantly "faster" than straight line in the early years, but significantly "slower" than the two other methods referred to above.

Net gains on sales of property used in the trade or business (with certain exceptions) are taxed as capital gains, and losses are treated as ordinary losses. In 1962, this was modified as to most personal property (and certain real property) to provide in general that gain on sale would be taxed as ordinary income to the extent of all the depreciation taken on that property after December 31, 1962. In 1964 the rules were modified as to buildings to provide in general that gain on sale would be taxed as ordinary income to the extent of depreciation taken after December 31, 1963; however, after the property has been held 12 months, only depreciation in excess of straight line is "recaptured" and taxed as ordinary income. Even that amount is reduced after 20 months, at the rate of 1 percent per month for 120 months, after which nothing is recaptured.

General reasons for change.—Accelerated depreciation will frequently allow deductions in excess of the amount required to service the mortgage during the early life of the property, thus producing in many cases a tax loss deductible against other income even though there is a positive cash flow. In addition, accelerated depreciation usually produces a deduction far in excess of the actual decline in the usefulness of the property. In addition, by holding the property for 10 years, the taxpayer can arrange to have all the gain resulting from excess depreciation (which was offset against ordinary income) taxed as a section 1231 gain, at capital gain rates. The tax advantage increases as the taxpayer's income moves into higher tax brackets.

As a result of the fast depreciation and the ability to deduct amounts in excess of the taxpayer's equity, economically profitable real estate operations normally produce substantial tax losses, sheltering from income tax the economic profit of the operation and permitting avoidance of income tax on the owner's other ordinary income, such as salary and dividends. Later, the property can be sold and the excess of the sale price over the remaining basis is treated as capital gain except for the limitations in section 1250.

Because of the present tax situation, when investment is solicited in a real estate venture it has become the practice to promise a prospective investor substantial tax losses which can be used to diminish the tax on his income from other sources. Thus, there is, in effect, substantial dealing in "tax losses" produced by depreciable real property. The committee, agreeing with the House, believes the desired solution is the elimination of these losses in those cases where there is no true economic loss.

Another problem with the present depreciation provisions is that they provide the same tax incentive to all real estate construction. This, in fact, tends to discriminate against the less profitable investments, particularly low income housing. In the 1968 Housing Act, the Congress expressed its desire to stimulate construction in low- and moderate-income housing to eliminate the shortage in this area, and, in part, based the incentive program thereby provided on the existing tax incentives. These circumstances suggest the need for maintaining the existing incentives for low income housing until the programs can be reevaluated.

In the housing field the tax stimulus has been more effective for luxury- and middle-income rental housing where profitability and appreciation prospects relative to risk are inherently more attractive than in lower income housing. The "trickle down" supply effect for the lower income rental housing market is slow and uncertain. Capital and other resource demands engendered by the existing tax stimulus tend to expand luxury housing, commercial, office, motel, shopping center, and other forms of investment, squeezing out lower income housing.

Still another difficulty with the present provisions is that the tax benefits are not focused on new construction but are spread over repeated turnover of older properties; this may support the market and prices for older housing, but the beneficial feedback to new construction incentive is not proportionate to the revenue cost.

The present treatment creates a tax environment favorable to frequent turnover which tends to discourage long-range "stewardship" and adequate maintenance; it also encourages thin equities and unsound financial structures which could topple if the market for real estate and rental housing weakened.

Finally, the present tax provisions provide no special incentive for improvements or remodeling of existing housing. In fact, the requirement of capitalization of costs of this nature, and tax recovery over an extended period, to some extent discourages such activity. This misallocation is especially unfortunate since it appears that remodeling of low-income projects faces special difficulties in obtaining conventional financing.

The committee agrees with the House that the current tax incentive aspects of real estate depreciation should be reduced, except as to new residential housing. In addition, it agrees that it is appropriate to encourage rehabilitation expenditures on low- and moderate-income rental housing.

Explanation of provision.—Both the House bill and the committee amendments contain provisions designed to reduce substantially the opportunities to avoid taxes as a result of accelerated depreciation for real estate. Both versions provide that new construction, other than residential housing, is to be limited to 150 percent declining balance depreciation. New residential housing is to continue to be eligible for the double declining balance or sum-of-the-years digits depreciation methods; however, accelerated depreciation is to be available only if 80 percent or more of the gross income from the building in the taxable year is derived from rentals of residential units.[1]

Used realty acquired in the future is to be limited to straight line or a comparable ratable method of depreciation. This provision is intended to eliminate the repeated sale and resale of property for the purpose of tax minimization.

The new rules curtailing accelerated depreciation on new real estate construction under both the House bill and the committee amendments are to apply unless (1) the construction of the building began before July 25, 1969, or (2) a written contract with respect to any part of the construction or for a substantial portion of the permanent financing was entered into before July 25, 1969. The House bill contained no exceptions for commitments with respect to used property. The committee amendments also provide that 150 percent declining balance depreciation is to continue to apply to used realty acquired under a binding contract entered into before July 25, 1969.

The committee also modified the House bill to allow accelerated depreciation with respect to a building yet to be constructed, if the tax-

[1] For purposes of the 80-percent test, interest reduction payments under FHA 221(d)(3) and FHA 236 programs are not to be considered as gross income from the building.

payer (or another member of an affiliated group) had filed with the appropriate local governmental authority, before July 25, 1969, an initial application for permission to construct, and if construction of such property is begun within one year after the date on which the initial application was filed. In addition, the committee amended the House bill to allow accelerated depreciation in the case of construction of residential housing in foreign countries but only to the extent that the foreign country allows accelerated depreciation on similar housing.

The committee, agreeing with the House on the importance of encouraging rehabilitation of buildings for low and moderate income rental housing, adopted the House provision to allow taxpayers to elect to compute depreciation on rehabilitation expenditures which are made on or after July 25, 1969, under the straight line method over a period of 60 months, if the additions or improvements have a useful life of 5 years or more. This rapid depreciation is to be available only for low income rental housing where the dwelling units are held for occupancy for families or individuals of low or moderate income, consistent with the policies of the Housing and Urban Development Act of 1968. The 60-month rule does not apply to hotels, motels, inns, or to other establishments where more than one-half of the units are used on a transient basis.

To qualify for the 60-month depreciation, the aggregate rehabilitation expenditures as to any housing may not exceed $15,000 per dwelling unit and the sum of the rehabilitation expenditures for two consecutive taxable years—including the taxable year—must exceed $3,000 per rental unit. These rules, in effect, place a ceiling and a floor on the amount of expenditures per rental unit which are to be taken into consideration for purposes of the special 5-year writeoff.

The committee modified the House bill by limiting the amortization of expenditures to those made prior to January 1, 1975. This will provide time for the Congress to evaluate the effectiveness and the cost of this new incentive.

The committee amendments, like the House bill, generally provide that where depreciable real estate is sold, accelerated depreciation taken in the future in excess of allowable straight-line depreciation is to be recaptured as ordinary income to the extent of the gain occurring upon the sale. However, the committee modified several aspects of the House bill regarding recapture of the excess of accelerated depreciation over straight-line depreciation. The House bill required recapture of all excess depreciation at ordinary income tax rates without allowing for a percentage reduction based on holding the property beyond a certain period of time. The committee amendments provide that excess depreciation on new residential housing is to be subject to recapture at ordinary income tax rates if the property is sold within 10 years. Thereafter, the amount of recapture at ordinary income tax rates is to be reduced by one percentage point for each month the property is held beyond 10 years. If the property is held for 18 years and 4 months, all gain realized on its sale would be taxed as capital gains.

The committee amendments also provide that the recapture rules of existing law are to be retained without change for Federal, state and locally assisted projects which are limited as to rate of return on the investment, such as the so-called FHA 221(d)(3) and FHA 236 programs. As a result, gain on the sale of such property will be taxed as ordinary income to the extent of the depreciation taken if held for less than twelve months; thereafter the excess of accelerated depreciation over straight-line depreciation will be recaptured at ordinary income tax rates if the property is sold within 20 months; then, the amount subject to recapture is to be reduced by one percentage point for each additional month the property is held beyond 20 months. These more favorable recapture rules are to apply only with respect to property constructed or acquired on or before December 31, 1974. This is designed to give the Congress an opportunity at that time to evaluate the effectiveness of this tax incentive program.[2]

The committee amendments also modify the House bill to retain the application of existing recapture rules where the sale of property was subject to a binding contract in existence prior to October 9, 1969, but where the transfer takes place after this date.

Full recapture, in accordance with the House bill, is required on all other realty to the extent accelerated depreciation taken after December 31, 1969, exceeds straight line depreciation. However, under the committee amendments the present recapture rules are to continue to apply with respect to depreciation attributable to periods after December 31, 1963, and before December 31, 1969. The House bill would have applied the new recapture rules to depreciation attributable to periods after July 24, 1969.

Effective date.—The changes made by this provision are to apply with respect to taxable years ending after July 24, 1969.

Revenue effect.—The provisions revising the depreciation allowances of real estate (including recapture of capital gain) will have little overall effect on revenue in 1970. However, the estimated revenue derived from the provisions will increase in later years and will reach about $1.3 billion in 1979. Of this amount, $250 million will be derived from the revised treatment of used property, about $960 million from new nonhousing properties, and about $100 million from the recapture provisions. The five-year rapid depreciation allowance provided for rehabilitation expenditures will involve an estimated loss of $330 million in 1979 assuming Congress decides to extend this provision beyond its 1974 termination date. If it is not extended, the overall revenue increase from the real estate provisions will be $1,310 million in 1979.

S. SUBCHAPTER S CORPORATIONS

(Sec. 531 of the bill and sec. 1379 of the code)

Present law.—Subchapter S was enacted in 1958 to permit the incorporation of small businesses (those with 10 or fewer shareholders) for business purposes without being subject to corporate tax, but instead having their shareholders taxed in a pattern roughly similar to the way in which partners are taxed. This election was granted in order to minimize the effect of Federal income taxes on businessmen's choices of the form of organization in which they conduct their business.

The subchapter S provisions do not deal with employee retirement plans. Consequently, these subchapter S corporations may establish corporate retirement plans for the benefit of shareholders who are also employees of the corporation. Prior to 1962, self-employed persons (proprietors and partners) were not able to establish such plans

[2] Another amendment in section 913, deals with sales of lower-income housing in limited circumstances.

to benefit themselves. By electing subchapter S treatment they could continue to avoid the corporate level of taxation and also could establish corporate retirement plans.

In 1962, Congress enacted the Self-Employed Individual Retirement Act (H.R. 10), permitting self-employed persons to be treated as employees of the businesses they conduct so that they may be covered under qualified employee retirement plans in much the same manner as their employees. These provisions, though, contain certain specific requirements as to proprietors and partners which limit contributions to 10 percent of the proprietor's or partner's earned income, or $2,500, whichever is less. These rules, however, do not apply to corporations.

General reasons for change.—The H.R. 10-type limitations on retirement income plans (described above) do not apply to corporations and so may be avoided by a proprietor or the partners of a partnership by forming a corporation, electing subchapter S treatment, and then becoming employees of the corporation. By the same token, a business that had incorporated without contemplating a subchapter S election can avoid the burden of the corporate tax while retaining its broad corporate retirement plan.

Both the House and the committee are concerned that a mechanism intended to simplify the tax complexity of corporations (studies are being made to determine, after a decade of experience with subchapter S, what changes should be made to provide greater simplicity) is instead becoming a method of avoiding the tax limitations of partnerships and proprietorships. The committee, like the House, believes that if an enterprise wants to incorporate for business purposes but wants to be taxed in a manner similar to a partnership, then it should be subject to the same H.R. 10 limitations as partnerships in the case of the tax treatment of pension plans.

Explanation of provision.—Both the House and the committee versions of the bill provide limitations, similar to those contained in H.R. 10, with respect to contributions to retirement plans for those individuals who are "shareholder-employees" of corporations that have elected to be taxed under subchapter S. For these purposes, a shareholder-employee is an employee or officer who owns at any time during the taxable year more than 5 percent of the shares of the corporation's stock, including ownership by application of family attribution rules (of sec. 318(a)(1)).

Under the bill, a shareholder-employee of a subchapter S corporation must include in his gross income the contributions made by the corporation under a qualified plan on his behalf to the extent the contributions exceed 10 percent of his salary or $2,500, whichever is less. Other employees who are shareholders but own 5 percent or less of the stock in the subchapter S corporation are not subject to this rule, and greater contributions may be made on their behalf without any amount being included in their income under this provision.

Unlike H.R. 10, excess contributions on behalf of shareholder-employees are not to have any effect on the qualified status of the plan. However, these excess contributions are to be regarded as having been made by the corporation for the purpose of determining whether the plan is qualified.

The amount of the contribution which the bill requires a shareholder-employee to include in his income is to be treated as his contribution to the trust. At the time of his retirement or other separation from employment entitling him to receive the benefits from the plan, his contribution is to be recovered tax free according to the rules for the tax treatment of annuities. When he begins to draw his pension or annuity, the tax-free part of the distribution is generally to be spread evenly over his probable lifetime, and the exclusion remains the same no matter how long he lives. If he is entitled to receive a lump-sum distribution instead of an annuity, the amount treated as his contribution is to be considered his basis so that he will not be taxed again on that amount.

Where a shareholder-employee or his beneficiaries do not receive those amounts which had been included in his gross income, a deduction is allowed, equal to the amount previously included in income, in the year the employee's (or his beneficiaries') rights under the plan terminate. This may occur where the employee terminates his employment, thereby forfeiting his benefits under the plan, or where he or his beneficiaries are receiving payments from the plan but, because of the employee's death, recover less in the aggregate than the amounts previously included in his gross income. In that situation, a deduction is allowed only for the amount not previously recovered.

The bill also requires, in the case of a stock bonus or profit-sharing plan, that the plan specify that any forfeitures of contributions that had been deducted in subchapter S years cannot benefit the shareholder-employees, except forfeitures of those contributions made in taxable years beginning before January 1, 1970. This requirement may be satisfied after the close of the taxable year if appropriate amendments to the plan are in effect by the 15th day of a third month following the close of that taxable year and they are effective for the entire period, beginning on the first day of that taxable year.

In the case of a stock bonus or profit-sharing plan, present law limits contributions each year to 15 percent of the compensation paid to the employees under the plan. However, any "unused" portion of this limitation may (subject to other limitations) be carried forward and applied to contributions in following years. The bill denies these carry-forwards to a corporation from a year when the corporation was an electing subchapter S corporation if the amount otherwise would be carried to a nonelecting year. However, the carryforwards from a nonelecting year may be used by a subchapter S corporation in an electing year.

Effective date.—This provision is to apply to taxable years of a subchapter S corporation beginning after December 31, 1969.

Revenue effect.—The revenue effect of this provision is expected to be small.

T. TAX TREATMENT OF STATE AND MUNICIPAL BONDS

(Secs. 601 and 602 of the bill and secs. 103(d), 6056 and 6685 of the code)

1. Election to Issue Taxable Bonds With Interest Subsidy and Information on Tax Exempt Holdings

Present law.—Present law provides that interest on obligations of State and local governments generally is exempt from Federal income tax, an exemption that has been provided ever since the Federal income tax was adopted in 1913.

Interest payments on obligations issued by the United States after September 1, 1917, are subject to Federal tax, in contrast with interest on State and local government obligations.

State and local governments generally do not directly tax interest on Federal bonds, but they tax the interest income on bonds issued by the States. Some States impose their income tax as a percentage of the Federal income tax liability, and in these cases the States, in effect, tax income on the Federal bonds.

The Revenue and Expenditure Control Act of 1968 withdrew tax-exempt status from industrial revenue bonds which State and local governments were using to finance and attract private industrial development within their jurisdictions. This legislation applies generally to industrial development bonds issued after April 30, 1968.

There are presently no other specific restrictions in the code upon these tax-exempt obligations or upon the use of the proceeds from their issue.

At present there is no information reporting on the size of the tax-exempt interest income received which the Federal government can associate with income tax returns.

General reasons for change.—The House report noted that tax savings for individuals and corporations from the purchase of tax-exempt bonds generally is greater than the differential between the interest yields on tax-exempts and taxable bonds. As a result, it has been estimated that the interest savings to State and local governments was $1.3 billion in 1968 but the tax revenue loss to the Federal government was $1.8 billion.

While there may be a problem here, the committee, because of its concern that any action with respect to State and municipal bonds could have a deleterious effect on the market for these bonds, and because of the high interest costs which are now being paid on new issues of such bonds, concluded that any action possibly having an impact on State and local government bond prices would be particularly unfortunate.

Explanation of provisions.—The House bill provided that States and local governments could voluntarily relinquish the privilege of tax exemption with respect to given debt-security issues and in these cases the Secretary of the Treasury would pay a fixed percentage of the interest yield on each such issue. Under the House bill, the fixed percentage to be paid by the United States could vary with respect to the debt securities issued in any calendar quarter within a range of from 25 to 40 percent of the interest yield. Up to 1975, however, the range was to be from 30 to 40 percent of the interest yield. The amounts were to be paid out of permanent Federal appropriations.

This provision would have applied to obligations issued in calendar quarters beginning after the date of enactment of the bill.

The committee amendments delete this provision from the bill. However, the committee amendments require that every person who receives or accrues $600 or more of interest on tax-exempt State and local government bonds (or who is required to file an income tax return for the year) is to make a return setting forth these amounts and any other information with respect to these bonds which the Treasury Department prescribes by regulations. The return is to be made in the time and manner prescribed by the Treasury Department, but, insofar as practicable, the regulations are to require the return to be made in connection with the regular individual and corporate income tax returns.

Failure to file this return (unless the failure is due to reasonable cause) is to result in a penalty of $10 or an amount equal to 5 percent of the interest received or accrued during the year, whichever is the larger, except that the penalty in no event is to exceed $1,000.

Effective date.—This provision is to apply to taxable years beginning after December 31, 1969.

2. Arbitrage Bonds

Present law.—Arbitrage bonds generally are obligations issued to acquire other securities where the rate of return of the other securities produces a higher yield than the interest cost on the initial bond issue. Present law does not specifically preclude the issuance of bonds for such purposes by State or local governments. However, questions have been raised in such cases as to whether such bonds in reality are obligations of a State or local government where the proceeds from the securities acquired secure the payments under the initial bonds. As a result, in recent years the Internal Revenue Service has refused to rule as to whether or not bonds issued in such circumstances constitute tax-exempt State or local government bonds.

General reasons for change.—Some State and local governments have misused their tax exemption privilege by engaging in arbitrage transactions in which the funds from the tax-exempt issues are employed to purchase higher yielding Federal or other obligations the interest on which is not taxed in their hands. The tax-exempt issue in these cases generally specifies that the interest on the Federal bonds or other obligations will be used to service the State and local securities. An individual who purchases a State or local security under such an arbitrage arrangement has the advantage of a tax-exempt security with the safety of a Federal security. The Federal Government then finds itself in the position of becoming an unintended source of revenue for State and local governments while losing the opportunity to tax the interest income from its own taxable bond issues. The Internal Revenue Service has announced that it will not rule on the question whether such arbitage obligations are entitled to tax exemption under existing law.

Explanation of provision.—Both the House bill and the committee amendments make provision for the taxation of arbitrage bonds issued by State or local governments. The House bill provided that, under regulations prescribed by the Secretary of the Treasury or his delegate, any arbitrage obligation was not to be treated as a tax-exempt State or local government bond. It was contemplated that the regulations issued by the Secretary of the Treasury would provide rules for the temporary investment of proceeds from the State or local government obligation pending their expenditure for the governmental purpose which gave rise to the issue.

The committee amendments also provide that arbitrage bonds are not to be treated as tax-exempt State or local government issues. However, under the committee amendments, arbitrage bonds are defined.

They are in general defined as obligations issued where all or a major part of the proceeds can be reasonably expected to be used (directly or indirectly) to acquire securities or obligations which may be reasonably expected, at the time of the issuance of the State or local obligation, to produce a yield which is materially higher than the yield on the State or local governmental bond issue. Arbitrage bonds are also defined as including obligations issued to replace funds which were used to acquire (directly or indirectly) the type of securities or obligations referred to above.

The definition of arbitrage bonds for purposes of this provision is not to include where substantially all of the proceeds of the issue are reasonably expected to be used to provide permanent financing for real property used, or to be used, for residential purposes (or to replace funds so used) where the yield on the State or local government obligations at the time of issue is not expected to be substantially lower than the yield on the permanent financing. (This exception does not apply to State or local government obligations held by a person who is a substantial user of property financed by the proceeds of the issue or by a member of his family.)

In addition, an obligation is not to be treated as an arbitrage bond solely because the proceeds of the issue may be invested in securities or other obligations for a temporary period until the proceeds are needed for the purpose for which the State or local government bonds were issued. Nor are obligations to be classified as arbitrage bonds where the proceeds of the State or local government issue may be invested in securities or other obligations which are part of a reasonably required reserve or replacement fund. The amount of the proceeds invested in securities or obligations which are part of a required reserve or replacement fund may not exceed 15 percent of the total proceeds of the issue unless the issuer establishes that a higher amount is necessary.

Effective date.—The committee amendments are effective with respect to obligations issued after October 9, 1969. The House provision would have applied to obligations issued after July 11, 1969.

Revenue effect.—The revenue effect from taxation of the interest income from arbitrage bonds is expected to be negligible, since the provision probably will eliminate such issues in the future.

U. EXTENSION OF TAX SURCHARGE AND EXCISE TAXES

1. Extension of Tax Surcharge at 5-Percent Rate for First Half of 1970 (sec. 701 of the bill and sec. 51 of the code)

Present law.—The Revenue and Expenditure Control Act of 1968 adopted a 10 percent surcharge on tax liabilities of individuals and corporations. The 10 percent surcharge initially would have expired as of June 30, 1969, but in H.R. 9951 the 10 percent surcharge was extended for the period from July 1, 1969, through December 31, 1969.

General reasons for change.—Inflationary pressures continue to demonstrate substantial strength throughout the economy despite indications in a few sectors of the economy that such pressures are weakening. In view of this outlook, the committee joins the House in recommending extension of the surcharge at a 5 percent rate for the first

6 months of 1970. It believes this is desirable to provide a gradual transition from an inflationary economic environment to an economy characterized by high levels of employment, balanced growth and expectations of stable prices.

In the third quarter of 1969, gross national product increased at an annual rate of $18 billion, after increases of $16.1, $16.2, and $16.1 billion in the three preceding quarters. Each of these increases is smaller than the increases which occurred during the first two quarters of 1968 (as large as $23.4 billion in the second quarter) before the surcharge was enacted and became an effective restraining force on spending. Real GNP, measured in 1958 prices has been increasing at a much slower rate during the past 4 quarters, declining from $5.7 billion in the fourth quarter of 1968 to $3.9 billion during the third quarter of 1969. As a percentage of the GNP increase in current prices, real GNP increases have been falling from 39.5 percent in the third quarter of 1968 to 35.4, 28.4, 22.4 and 21.7 percent respectively in each of the succeeding quarters. This comparison indicates continuation of substantial pressure on prices although the rate of economic activity has been slowing.

Since September 1968, the consumer price index has increased by 6.2 percent, and the wholesale price index has risen by 4.5 percent. These substantial rates of increase are reflected in the difference between the increases in GNP in current prices and in constant (or 1958) prices. The picture of slowly increasing effectiveness of the policies of economic restraint can be illustrated partly by the differences between these two indexes between July and October when the consumer price index increased at an annual rate of 5.0 percent and the wholesale price index at an annual rate of 2.4 percent. Since general price increases work their way through the production process from raw materials to finished goods sold at retail, the recent reduced rate of increase in wholesale prices during those three months might be a harbinger of relatively more stable prices to come.

Financial and money markets continue to show signs of inflationary demands for credit. Interest rates remain high. The prime rate of interest continues at 8.5 percent, and the yields on Aaa rated corporate bonds was 7.41 percent and on long-term U.S. Government bonds was 6.67 percent on November 20, 1969. Since mid-April, the average level of weekly net reserve borrowings by member banks from the Federal Reserve System has been in excess of $1 billion and generally has varied within a range of $900 to $1,200 million.

Furthermore, the balance of payments continues to be in deficit. Until the start of this inflation, the balance of trade in goods and services produced a substantial surplus that offset most of the financial and capital transactions that produced a deficit. Capacity levels of production and inflated prices have discouraged exports and have improved the competitive position of imports. The most important single contribution that can be taken toward improving the balance of payments is to halt inflation. This would make it easier to increase exports and to reduce imports. Success in improving the balance of payments will make the dollar stronger in foreign exchanges.

Explanation of provision.—Both the House bill and the committee amendments provide that the surcharge on the tax liabilities of individuals and corporations is to be continued at a 5-percent annual rate for the period from January 1, 1970, until June 30, 1970. Since this 5-percent surcharge will be applicable only for the first half of 1970, the surcharge for the entire year 1970 will be 2½ percent for a calendar-year taxpayer.[1]

The other provisions of existing law dealing with the manner in which the surcharge applies and is computed are not changed by either version of the bill except for a conforming amendment relating to the required amount of minimum distributions which a domestic corporation must receive from its foreign subsidiaries in order to avoid including undistributed earnings of foreign subsidiaries in its own income.

Effective date.—This provision applies to taxable years ending after December 31, 1969, and beginning before July 1, 1970.

Revenue effect.—It is estimated that the extension of the surcharge at a 5-percent rate for the period January 1, 1970 to June 30, 1970 will increase liability of taxpayers in 1970 by $3.1 billion. In the fiscal year 1970, revenues will increase by $2 billion.

2. Continuation of Excise Taxes on Communication Services and Automobiles (sec. 702 of the bill and secs. 4061 and 4251 of the code)

Present law.—The excise tax on passenger automobiles (imposed on the manufacturer's sales price) presently is 7 percent through December 31, 1969. Under present law there is a reduction of the rate after that time to 5 percent during 1970, to 3 percent during 1971, and to 1 percent during 1972. The tax then is repealed as of January 1, 1973.

The excise tax on amounts paid for local and toll telephone services and teletypewriter exchange services is 10 percent prior to January 1, 1970. On that date, present law provides that the rate is to begin a gradual reduction to 5 percent during 1970, to 3 percent during 1971, and to 1 percent during 1972. The tax is then repealed as of January 1, 1973.

General reasons for change.—Both the House and the committee concluded it would be inappropriate to repeal this type of fiscal restraint which has been used in the program to end inflationary pressures. Present excise tax levels have been maintained as integral parts of the anti-inflation program, and a reduction in these rates would weaken the program before the objectives of stable prices and employment and balanced growth have been achieved. In view of these considerations, this bill provides for the continuation of the 7 percent manufacturer's automobile excise tax for another year, or until January 1, 1971. It also provides for the postponement of the reductions in the automobile excise tax scheduled for future years for one additional year in each case. On a similar basis, the bill provides for a continuation of the communications services tax on local and toll telephone and teletypewriter exchange services. The present 10 percent tax is continued for another year, or until January 1, 1971. Future scheduled reductions also are to occur 1 year later than provided under present law.

Explanation of provision.—As indicated above, the committee agrees with the House that it is appropriate in view of budgetary and

[1] In the case of a fiscal year taxpayer, the surcharge is at an annual rate of 10 percent for the period ending Dec. 31, 1969, and at an annual rate of 5 percent for the period beginning Jan. 1, 1970, and ending June 30, 1970. The rate for any fiscal year, only a part of which is in the 10-percent or 5-percent surcharge period, is to be determined by a proration of the two periods on a daily basis.

economic conditions to postpone, for 1 year, the scheduled reductions in the excise taxes on passenger automobiles and communications services. Accordingly, both versions of the bill provide that the current rates are to continue through 1970 and each subsequent scheduled reduction is to be postponed 1 year. Under the bill, the schedules of rates for the excise taxes on passenger automobiles and communications services are as follows:

	Rate (percent)	
	Automobiles	Communications services
1970	7	10
1971	5	5
1972	3	3
1973	1	1
1974	(1)	(1)

1 Tax is repealed.

Effective date.—The amendments made by this provision become effective on January 1, 1970.

Revenue effect.—It is estimated that the continuation of these excise taxes at present rates for 1 more year will result in a revenue increase of $540 million in the fiscal year 1970, of which $300 million is attributable to the passenger automobile tax and $240 million to the tax on communication services. In the fiscal year 1971 these extensions are expected to raise revenues by $1.07 billion of which $540 million is attributable to the passenger automobile excise tax and $530 million to the excise tax on communications services.

V. REPEAL OF THE INVESTMENT CREDIT

(Sec. 703 of the bill and secs. 46, 47, and 49 of the code)

Present law.—Present law provides a 7-percent tax credit (3 percent for public utility property) with respect to qualified investment. In general terms, the investment credit is available with respect to: (1) tangible personal property; (2) other tangible property (not including buildings and structural components) which is an integral part of manufacturing, production, etc., or which constitutes a research or storage facility; and (3) elevators and escalators. In addition, the property must be depreciable property and have a useful life of 4 years or more. New property fully qualifies for the credit, but in the case of used property only an amount up to $50,000 can be taken into account in any year. Property with a useful life of from 4 to 6 years qualifies for the credit to the extent of one-third of its cost. For property with a useful life of 6 to 8 years, qualification is with respect to two-thirds of the investment, and for property the estimated useful life of which is 8 years or more, the full amount qualifies.

The amount of the investment credit taken in any year may not exceed the first $25,000 of tax liability (as otherwise computed) plus 50 percent of the tax liability in excess of $25,000. Investment credits which because of this limitation cannot be used in the current year may be carried back to the 3 prior years and used in those years to the extent permissible within the limitations applicable in those years, and then, to the extent of any amount still remaining, carried forward and used to the extent permissible under the applicable limitations, in the succeeding 7 taxable years.

General reasons for change.—After careful consideration of the sources of the present inflationary pressures, the committee concluded that the stimulus to investment which is provided by the credit contributes directly to these pressures. In addition to its effect on inflationary pressures, the present level of investment cannot be maintained for more than a short period of time, and it is important for the long-run vitality of the economy to keep the level of investment on a steady growth path. Wide fluctuations in the level of investment are transmitted quickly throughout the rest of the economy, and the effects are multiplied.

The committee also concluded that a tax credit of this type which encourages spending for investments is inappropriate and inconsistent with national economic policy that applies a surcharge on individual and corporation income tax liabilities, in part at least, to restrain spending by business and consumers. The evidence of present heavy expenditures in the investment sector of the economy suggests that the removal of this special inducement to spending will be of special assistance in bringing inflation under control. Moreover, the revenue it provides makes possible the reduction of the income tax surcharge from 10 percent to 5 percent on January 1, 1970, rather than continuing the full 10-percent rate until June 30, 1970.

Continued availability of the investment credit during the present inflationary period serves to offset the effect of anti-inflationary fiscal and monetary policies. While tight money, budgetary surpluses, and higher taxes generally serve to discourage investment during an inflationary period, the investment credit significantly reduces their effects. Tight monetary policy is partially neutralized because the investment credit increases the supply of internal funds and reduces a firm's need to enter the money market to finance new investment. Higher taxes tend to reduce the internal supply of funds, but the investment credit tends to restore the supply. As a result, business firms can advance their investment plans to get ahead of anticipated higher prices in the near future, and their additions to otherwise normal current investment demand contributes to even higher prices. This investment does not increase the long-run growth of productive capacity because the investment would have been made anyway, although at a later date, but it does tend to reduce post-inflation investment. Inflation-motivated investment also tends to drive up the cost of plants and equipment, thus contributing to a cost structure of the economy which may be permanently higher than it would have been if investment had taken place more gradually.

Because the investment credit tends to reduce the effectiveness of a tight monetary policy, its presence apparently makes it necessary to impose more severe monetary restraints than would otherwise be necessary. Since the monetary restraints are much broader in their application than the investment credit, this results in distortions in other areas of the economy where the credit is not applicable. This effect presents special hardships to residential housing, small businesses, and investments by State and local governments.

The effects of the tight monetary policy have been particularly evident since the beginning of 1966. Its most recent manifestation was the increase in the prime rate to 8½ percent on June 9, 1969 (the rate of interest major commercial banks charge their highest rated borrowers on loans), a rate that has continued in effect to date. On November 20, 1969, the yield on Aaa corporate bonds was 7.41 percent, and on long-term governments the yield was 6.67 percent. The pressure of monetary policy on commercial banks is shown by the reserve position of member banks. Free reserves of member banks—the difference between excess reserves and borrowings at Federal Reserve banks—have been in deficit throughout the past year, but the deficits have increased substantially during 1969. The estimated weekly net deficit has averaged more than $1 billion since mid-April, varying generally between $900 and $1,200 million. There was a brief decline in net borrowed reserves during September when they fell as low as $405 million on September 10 and varied between $860 and $903 million during the rest of the month. Since September, however, net borrowed weekly reserves rose again to the $900 to $1,200 million range.

Recently published Department of Commerce data show that expenditures for producers' durable equipment—composed primarily of equipment eligible for the investment credit—has increased as a percentage of gross national product for the past four quarters over the level in mid-1968. During the second and third quarters of 1969, the ratio has been above 7 percent, a point which indicates an unsustainable level of demand. (The ratio increases when purchase of producers' durable equipment increase proportionately faster than gross national product.)

The August Department of Commerce-Securities and Exchange Commission survey estimates of business plans for purchases of new plant and equipment in 1969 indicate a planned increase of 10.6 percent over 1968 investment levels. In the past decade, the increases exceeded 10.0 percent only in 1965 (15.7 percent) and 1966 (16.7 percent), and those years of investment boom also produced backlogs of orders for certain producers' equipment that involved delays of 10 months or more before expected delivery.

In the period June–September 1969, the order backlog for metal-cutting tools averaged 9.3 times monthly shipments, and the order backlog for metal-forming tools averaged 11.7 times monthly shipments. On a consolidated basis, the order backlog for these producers' tools averaged almost 10 times average monthly shipments.

Commerce-SEC survey estimates of business plans for purchases of new plant and equipment in 1970 have not been completed as yet. Three private surveys have been released of 1970 estimates which forecast increases in capital investment of 7 to 9 percent over present estimates of the 1969 level. The latest survey released by McGraw-Hill's Economics Department estimates an 8.3 percent increase in new plant and equipment expenditures in 1970. Since the latest survey was conducted after House action to repeal the investment credit and the Finance Committee's reporting two bills that also repeal the investment credit, the results clearly indicate that the prospective repeal has contributed to offsetting the excesses of inflationary expectations without inducing a cutback in new plant and equipment expenditures. By implication, the manageable level of increase represented by the 8 percent estimated increases substantiates the decision to repeal rather than suspend the credit.

The committee faced the choice of suspending the investment credit, which is what Congress did in 1966, or repealing the credit. A review of the experience during the suspension period revealed that suspension became a positive deterrent to investment as the end of the period was approached. Businessmen realized that by postponing their investments a few months, these investments would again be eligible for the credit. It is undesirable to repeat that experience, and the committee decided that repeal of the credit was the realistic choice.

In addition, the investment credit does not lend itself well to suspension, restoration, and then suspension again. Investment plans are made on the basis of the availability of the investment credit and various commitments are then made on this basis. Then, when the credit is suspended, taxpayers are caught in various states of commitment to invest. On one hand, the result is the need for a series of special provisions in a bill suspending or repealing the credit (included in the 1966 act and also in this bill) which provide for those cases where a facility has not been put in service but there is a substantial commitment for specific investments and where the injury from removal of the credit is substantial. On the other hand, no matter where in the planning-commitment process the line is drawn, or how carefully as to the cases covered or not covered by the investment credit, it is of necessity somewhat arbitrary and unsatisfactory to those in the planning-commitment process who just miss eligibility for the credit.

Because of the double economic effect of suspension of the investment credit and because of the administrative problems involved in turning the investment credit off and on, the committee has concluded that it is better to repeal the investment credit than to suspend it. Moreover, even though an investment credit may have been useful in the past in inducing investment in periods when there was a large deficiency of investment, it is not clear that the same type of problem will be faced in the future. For this reason also, the committee concluded that it was better to repeal the credit, rather than suspend it. If the need should, in the future, arise for a further stimulant to investment, the Congress will then be free to consider various alternative types of treatment. Moreover, it is not clear, once the appropriate rate of investment has been restored, whether in the future special inducements to investment will again become necessary. It may well be that the normal incentives of potentially greater profits in the context of a stable growth, full employment economy will provide the investment needed without resort to special devices to stimulate investments which, on occasion, appear to give rise to investment booms.

Explanation of provision.—The provision to repeal the investment credit in the committee amendments is, in most respects, the same as the investment credit provision passed by the House.

(*i*) *Repeal of investment credit.*—Both the House bill and the committee amendments provide that the investment credit is not to be available with respect to property, the physical construction, reconstruction, or erection of which is begun after April 18, 1969, or which is acquired by the taxpayer after that date. As a result, the investment credit generally is not to be available for property acquired after

April 18, 1969, by a taxpayer even though the construction of the property (by someone other than the taxpayer) began before that date. Both versions of the bill also provide certain exceptions to this general rule under which the investment credit is to be available in the case of property which is constructed (reconstructed or erected) or acquired under a binding contract entered into before April 19, 1969, or in other transitional situations which are discussed below. The binding contract rule and other transition rules provided are in general the same as the rules provided by Congress in 1966 in connection with the suspension of the investment credit.

The construction of property is to be considered as begun when work of a significant nature has begun with respect to the property. This means that if the foundation or installation is significant and this has begun, the construction of the property will be considered to have begun. Also, if manufacturing of important parts of the property has begun, construction will be considered as commenced. Similarly, if assembly of parts (other than for inventory) has begun, this too will indicate the beginning of the construction of the property. However, construction of a facility or equipment will not be considered as begun if work has begun only on minor parts or components of it. For example, in the case of the construction of a transistor to be used in a computer, the beginning of the construction of the transistor will not mean the beginning of the construction of the computer.

To overcome difficulties a number of companies might otherwise have in identifying, under their accounting systems, whether a particular item placed in service was acquired on or before April 18, 1969, or pursuant to contracts that were binding on that date, a first-in-first-out rule is to be followed. The problem arises where the companies regularly acquire (or manufacture themselves) and maintain a large stock of identical or similar pieces of property to be placed in service as needed. The accounting systems may not identify, with respect to each item, the date it was acquired or constructed (or the date the contract for its acquisition was entered into). In these situations, the companies are to assume that the first items put in service after April 18, 1969, were those they had on hand or which were under a binding contract on that date.

(*ii*) *Availability of credit.*—The investment credit is available at the time the property is placed in service or, in other words, when the depreciation with respect to the property begins. In the House bill, it was provided that the 7-percent investment credit which would otherwise be available in the case of property placed in service after 1970 (generally because the property qualified under the binding contract or other transition rules) was to be reduced by one-tenth of 1 percentage point for each full calendar month after November 1970 and before the time the property is placed in service. In addition, no credit was to be allowable for property placed in service after 1974.

The committee agrees with the House that the investment credit should not continue to be available indefinitely even where, for example, property is acquired pursuant to a pre-April 19, 1969, binding contract. The committee believes, however, that the phaseout procedure provided by the House provisions unduly discriminates against those taxpayers who had contracted for the purchase or construction of long lead time equipment. In these cases the contract was entered into with the contemplation that a 7-percent investment credit would be available for the property. The fact that a long lead time item is involved, however, would result in the taxpayer receiving a reduced credit. To remove this inequity and to insure that taxpayers will receive for a reasonable period of time the credit they had contemplated when they became substantially committed to the acquisition of property, the committee amendments provide that the 7-percent investment credit is to continue to be available for property placed in service through the end of 1978. Thus, where property qualifies for the credit because of the binding contract or other transition rules, a full credit will be available for the property if it is placed in service prior to January 1, 1979. No credit will be available for property placed in service after 1978.

(*iii*) *Carryovers of unused investment credits.*—At the end of 1968, taxpayers had approximately $2 billion of unused investment credits. If these unused credits were allowed to be carried over and used without limitation (other than the general 50 percent of tax liability limitation), much of the revenue gain and economic restraint which could otherwise be expected in the fiscal year 1970 arising from the repeal of the investment credit would be eliminated. To avoid this effect, both the committee amendments and the House bill provide a limit on the amount of unused credits which may be carried over to 1969 and each subsequent year.

Generally, this limitation would restrict the amount of unused credits which a taxpayer can claim as carryovers in any year after 1968 to 20 percent of the aggregate amount of unused credits otherwise available as a carryover to the year in question.

The committee amendments also provide an additional 3-year carryforward period for unused investment credits which may not be used as a carryover in a taxable year solely because of the new 20-percent limitation. This additional carryforward which was not included in the House bill is designed to minimize the possibility that the limitation may operate to completely deny taxpayers the benefit of investment credits which they have already earned. This can occur where the special limitation prevented the use of an unused credit carryover and the regular 7-year carryforward period expired.

Under both versions of the bill the amount of unused credits which a taxpayer can claim as carryovers to any year beginning after 1968 is to be subject to a special limitation. The special limitation provides that the credit taken, attributable to the carryovers, cannot exceed 20 percent of the aggregate amount of the taxpayer's unused investment credits which otherwise would have been available as carryovers to the year in question after 1968, or any prior year after 1968 if the carryovers to that year are higher than in the current year (the aggregate carryovers are computed by taking into account carryforwards from prior years and carrybacks from subsequent years; carrybacks from subsequent years retroactively increase the limitation). This limitation on the amount of unused credits which may be used as carryovers in a year applies in 1969 and in each subsequent taxable year.

The special limitation provided by the bill on the use of carryovers is in addition to the general 50 percent of tax liability limitation on the amount of investment credit which a taxpayer may claim in a year.

The rules of present law regarding the order in which unused credit carryovers to the current year from two or more other years are to be used in the current year (the unused credits of the earliest year involved are used first, then the unused credits from the next earliest year are used, and so forth) are to continue to apply.

The committee amendments (but not the House bill) also provide that unused investment credits which may not be used as a carryover in a taxable year solely because of the 20-percent limitation may be carried over for an additional 3 years. In other words, to the extent an unused credit could have been carried over to a year and used in that year under the general 50 percent of tax liability limitation but because of the 20-percent limitation cannot be so used, an additional 3-year carryover period is to be available. The use of the carryovers during the additional 3-year period are to be subject to the general 50 percent of tax liability limitation and the 20-percent limitation in those subsequent years.

The operation of the limitation provided by the committee amendments may be illustrated by the following example. Assume a calendar year taxpayer has $500 of unused investment credits from years prior to 1969 which otherwise would be available as carryovers to 1969. Under the limitation, a $100 limit (20 percent of $500) would be placed on the amount of carryovers which the taxpayer could use in 1969 and in each subsequent year. If in this case the $500 of unused credits were composed of $150 of unused credits arising from the year 1962 and $350 of unused credit arising from the year 1968, and, in the absence of the special 20-percent limitation (i.e., under the general 50 percent of tax liability limitation), the taxpayer could have claimed $125 of the carryovers in 1969, then an additional 3-year carryover period is provided for $25 of the $50 of the carryover from 1962 which could not be used in 1969. This is the amount of the carryover from 1962 which could have been used in 1969 under the general limitation but could not be used because of the special 20-percent limitation. Since the other $25 of the carryover could not have been used in 1969 under the general limitation, no additional carryover period is provided for this amount.

If the taxpayer in this example should place property in service in 1972 which is eligible for the investment credit (generally because of the binding contract rule or another transition rule) and as a result of the 50 percent of tax liability limitation in 1972 there should be an unused investment credit in that year, the fact that the unused credit would otherwise be available as a carryback to 1969 would operate to retroactively increase the limitation on the use of carryovers in 1969. For example, if the unused credit arising from the investment in 1972 were $300, this would have the effect of increasing the amount of unused credits which otherwise could be carried over to 1969 to $800 (the $500 of carryforwards from years prior to 1969 and the $300 carryback from 1972). Accordingly, the limit on the use of carryovers in 1969 would be retroactively increased to $160 (20 percent of $800). Under the basic rule that the carryovers to a year which are actually used in that year are considered to be the unused credits arising from the earliest year involved, the retroactive increase of the carryover limitation from 1969 to $160 means that all of the taxpayer's $150 of unused credits arising from the year 1962 then become usable under the special limitation as a carryover in 1969 (however only $125 would be allowable in 1969 under the 50-percent limitation).

The new $160 limitation on the use of unused credit carryovers in this example would continue to apply in each of the years after 1969 unless the aggregate amount of unused credits otherwise available as carryovers to one of those years (taking into account both carryforwards of remaining unused credits and carrybacks of unused credits arising from subsequent investments under the binding contract rule or another transition rule) exceeded $800 (the carryover amount used in determining the $160 limitation). In such a case, a new limitation based on the higher amount of carryovers would be determined which then would be applicable in that year and in subsequent years.

(*iv*) *Binding contracts.*—Under both versions of the bill the investment credit is to be available with respect to property which is constructed (reconstructed or erected) or acquired pursuant to a contract that was binding on the taxpayer at the close of April 18, 1969, and at all times thereafter. This provision applies only to contracts in which the construction, reconstruction, erection, or acquisition of property is itself the subject matter of the contract, and does not apply to a contract with a person other than the builder or supplier under which the taxpayer becomes obligated to construct, reconstruct, erect, or acquire property. A supplier for this purpose need not be the person who manufactures the property which is being acquired, but may be a distributor or other type of middleman. (To the extent so-called third party leases and contracts are intended to be covered, see subsequent discussion.) Thus, a contract with a financial institution, a bond underwriter, or a labor union under which the taxpayer is obligated to acquire property is not covered by this provision.

Whether or not an arrangement between a taxpayer and a builder or supplier constitutes a contract is to be determined under the applicable local law. A contract for this purpose may be oral or written. However, in the case of an oral contract, the taxpayer must establish by appropriate evidence that the contract was, in fact, entered into before the close of April 18, 1969. This may be done by memorandums, the conduct of the parties or other evidence that a contract was in fact entered into. State law as to the effect of "part performance," and as to when a seller has accepted an order will apply.

A binding contract for purposes of this provision exists only with respect to the property which the taxpayer is obligated to accept under the contract. Thus, when prior to April 19, 1969, a taxpayer had contracted to purchase a lathe but not the motor to run the lathe, the investment credit is denied under this rule only with respect to the motor (but see special 50-percent rule for machinery and equipment set forth below). In addition, where a contract obligates a taxpayer to purchase a specified number of items and also grants him an option to purchase additional items, the contract is binding on the taxpayer only to the extent of the items he must purchase. Similarly, where the taxpayer is bound under a contract to purchase either of two or more specified items, this rule applies only to the extent of the contract price of the least costly of the items which may be selected.

A contract may be considered binding on a taxpayer even though (*a*) the price of the item to be acquired under the contract is to be determined at a later date, (*b*) the contract contains conditions the occurrences of which are under the control of a person not a party to the contract, or (*c*) the taxpayer has the right under the contract to make minor modifications as to the details of the subject matter of the contract. These rules may be illustrated by the following examples:

A contract to buy a specified type, grade, and amount of steel, the price to be the market price on the day of delivery, may be a binding contract. A contract which is conditioned upon obtaining of a certificate of convenience and necessity from a public utilities commission may be a binding contract. Where, under a contract to purchase a machine tool, the purchaser has the right to modify the specifications for the tool to reflect current technological advances, the contract may be a binding contract. Similarly, where a contract contains a condition which is under the control of one of the parties to the contract and this party is obligated (either by the specific terms of the contract itself or by operation of State law) to use his best effort to secure the occurrence of the condition, the existence of the condition in the contract does not prevent the contract from being one which is binding on the taxpayer. For example, if a contract to purchase equipment is conditioned upon the supplier being able to supply the equipment within a specified period of time and the supplier is obligated to use his best efforts to satisfy this condition, the contract may be a binding contract.

On the other hand a contract which is binding on a taxpayer on April 18 will not be considered binding at all times thereafter if it is substantially modified after that date. A waiver of a right to cancel upon a price change is an example of a substantial modification.

A contract under which the taxpayer has an option to acquire property is not a contract that is binding on the taxpayer for purposes of this provision unless the amount paid for the option is forfeitable (if the taxpayer does not exercise his option), is to be applied against the purchase price of the property (if the taxpayer exercises his option) and then only if the amount paid for the option is not nominal. Similarly, a contract which limits the damages to be recovered, in the event of a breach by the purchaser, to the amount of a deposit or to liquidated damages is not a binding contract if the deposit or the liquidated damages are nominal in amount. In determining whether a deposit, or liquidated damages, or the amount paid for an option is nominal, the size of the deposit, etc., relative to the contract price of the property which is the subject matter of the contract is to be taken into account. If the deposits, etc., are a significant portion of the price of the item, the contract may be a binding contract. For example, a deposit of $50,000 in connection with a contract to acquire property at a price of $1 million is a significant portion of the contract price.

Where an order for the purchase of property may be canceled by the purchaser within a specified period of time, such as 90 days, the order is a contract binding on the purchaser if the period of time had expired before April 19, 1969, or the right to cancel the contract had been terminated before that date by partial performance with the buyer's consent. Similarly, the right of a buyer under a contract for the acquisition of property to cancel the contract if the seller raises the selling price, a so-called price escalation clause, does not prevent the contract from being binding on the buyer until the buyer becomes entitled to exercise his cancellation rights.

If a taxpayer who had entered into a contract for the construction of property prior to April 19, 1969, completes the contract himself because of the default of the other contracting party, the taxpayer is considered to have a binding contract to the extent that he was bound on the contract prior to the default.

There would not be a binding contract if the property to be supplied is not specifically identified and determined before April 19, 1969. Thus, for example, if a financier has agreed with an airline to buy planes and lease them to the airline when requested (whether or not some maximum is provided), there is no binding contract as to those planes which were not requested before April 19. However, this is not intended to foreclose the allowance of the investment credit in the case of a contract to lease, which in all respects was binding on the lessor on or before April 18, 1969, where the lessee was not required to take a specified amount of the property in question if the lessor retained the investment credit with respect to the property. In this case, the party having the investment credit has a binding contract.

(*v*) *Equipped building rule.*—It is realized that once construction on a building has begun there are likely to be commitments which make it necessary to complete the building as well as to acquire machinery and equipment [1] and appurtenances necessary to the operation of the building. Therefore, both versions of the bill contain a rule which, in general, provides that where construction of a building has begun, before April 19, 1969, and the cost of the building plus any machinery and equipment for it which has been ordered (under a binding contract) or constructed before April 19, 1969, represents more than half of the entire cost of the building and planned equipment, the entire equipped building project and incidental appurtenances are to be eligible for the investment credit to the extent they would otherwise qualify for the credit. Where the costs incurred before April 19, 1969, do not equal more than half the cost of the equipped building, each item of machinery and equipment is to be treated separately (as provided in existing law) for purposes of determining whether the item qualifies for the investment credit.

It is recognized of course, that there are various types of commitments which are made before physical construction has commenced or a binding contract has been entered into which, although they occurred before April 19, do not result under either version of the bill in the allowance of the investment credit. In part, these were not taken into account because their varied nature makes it impossible to specify with certainty in the statute those cases where the investment credit would be available and those cases where it would not.

The equipped building rule provided in the two versions of the bill specifies that the investment credit is to be available with respect to the equipment and machinery to be used in the completed building, and also incidental machinery, equipment, and structures adjacent to the building (referred to here as appurtenances) which are necessary to the planned use of the building, where the following conditions are met:

[1] The term "machinery and equipment" is generally used here to denote property which is of a type that is eligible for the investment credit.

(a) The construction (or reconstruction or erection) or acquisition of the building, machinery, and equipment was pursuant to a specific plan of a taxpayer in existence on April 18, 1969; and

(b) More than 50 percent of the adjusted basis of the building and the equipment and machinery to be used in it (as contemplated by the plan) was attributable to property on which either construction has begun before April 19 or which was acquired or under binding order before April 19.

In applying this 50-percent test, the machinery or equipment ordered or constructed before that date which are taken into account include the cost of essential parts or components ordered subsequently which, under the special machinery and equipment rule (explained below), are to be eligible for the investment credit. This rule, of course, does not allow the taxpayer to add machinery and equipment with respect to a building under construction at will, since the building and equipment must be a part of a specific plan of the taxpayer in existence before April 19, 1969. While this plan may be modified to a minor extent after that date (and the property involved still come under this rule), nevertheless, there cannot be substantial modification in the plan if this equipped building rule is to apply. The plan referred to here must be a definite and specific plan of the taxpayer which, in one form or another, is available as evidence of the taxpayer's intentions.

The equipped building rule can be illustrated by an example where the taxpayer has a plan providing for the construction of a $100,000 building with $80,000 of machinery and equipment to be placed in the building and used for a specified manufacturing process. In addition, there may be other structures or equipment, here called appurtenances, which are incidental to the operations carried on in the building which are not themselves located in the building. Assume that the incidental appurtenances have a further cost of $30,000. These appurtenances might include, for example, an adjacent railroad siding, a dynamo or water tower used in connection with the manufacturing process, or other incidental structures or machinery and equipment necessary to the planned use of the building. Of course, appurtenances, as used here, could not include a plant needed to supply materials to be processed or used in the building under construction. In this case, if construction on the building had begun but no equipment had been ordered, and the appurtenances had not been constructed or placed under binding order, nevertheless, the entire equipped building and appurtenances, to the extent property of a type qualifying for the investment credit was involved, would be eligible for the investment credit. This can be seen by the following analysis of this example: the cost of the equipped building in this case was $180,000 and since construction on the building had commenced, the machinery and equipment, even though not under binding order, would be eligible for the investment credit as a result of this rule. This is true because the building cost represents more than 50 percent of the total $180,000. In this connection, it should be noted that the additional cost of the appurtenances, $30,000, is not taken into account for purposes of determining whether the percentage requirement is met. However, the investment credit would be available with respect to these appurtenances since the 50-percent test is met as to the equipped building.

Although the above example is one in which the construction of the building had commenced while the machinery and equipment had not been ordered, in other cases the reverse may be true. If the machinery and equipment contracted for is the major portion of the total cost in such a case, the investment credit is to be available with respect to the entire equipped building (to the extent eligible for the investment credit) even though the construction of the building itself has not commenced.

(*vi*) *Plant facility rule.*—Both versions of the bill also provide a plant facility rule which is comparable to the equipped building rule (explained in (*v*) above) to provide for cases where the facility is not housed in a building.

Under modern practices many production facilities, which in the past were housed in buildings, are erected out in the open. This has been made possible by improved technology and is desirable in many of these cases for reasons of safety and economy. The plant facility provision provides, in effect, two rules. The first of these rules is applicable where construction of the facility at the site had not commenced on April 18, 1969. The second rule covers the situation where such construction had commenced.

Under the first rule, if a taxpayer, pursuant to a plan in existence on April 18, 1969, constructed, reconstructed, or erected a plant facility (or portion thereof) and more than 50 percent of the aggregate adjusted basis of the depreciable property which makes up the facility is attributable to either (1) property the construction, reconstruction, or erection of which was begun by the taxpayer before April 19, 1969, or (2) property the acquisition of which by the taxpayer occurred before that date, then all property of the type which is generally eligible for the investment credit which makes up the facility is to continue to be eligible for the credit. This rule only applies if the plan under which the facility is constructed, etc., is not substantially modified after April 18, 1969, and before the facility is placed in service.

In determining whether the 50-percent requirement of this rule is met, installation costs and engineering costs which are capitalized and have been incurred prior to April 19, 1969, are to be taken into account. In addition, such costs which had not been incurred prior to that date but which are attributable to property construction, etc., of which had begun prior to April 19, or property which had been acquired prior to April 19, are to be taken into account for this purpose.

As in the case of the equipped building rule, property on order under a binding contract in effect on April 18, 1969 (and thereafter), is included in determining whether the facility meets the 50-percent requirement. The rules dealing with binding contracts (explained in *iv* above) are applicable to this provision. Similarly, property which qualifies under the special machinery and equipment rule (explained in *vii* below) is to be included in determining whether the facility meets the 50-percent requirement.

This provision defines a plant facility to be a facility which meets the following requirements. The facility must not include a building, other than buildings which constitute an insignificant portion of the facility. In addition, it must be (1) a self-contained, single operating unit or processing operation, (2) located on a single site, and (3) identified on April 18, 1969, in the purchasing and internal financial plans of the taxpayer as a single unitary project.

The fact that the facility does not produce a commercially marketable product is irrelevant in determining whether or not a particular facility is a plant facility for purposes of this provision. Furthermore, the fact that a single operating unit or processing operation is connected, by pipes, conveyor belts, etc., to one or more other units or processing operations in an integrated processing or manufacturing system does not cause the whole system to be a plant facility. Examples of self-contained, single-operating units or processing operations which may constitute a plant facility under this rule are a railroad switching yard, a railroad bypass route, a pipeline route or right-of-way, and an ethanolamines unit.

The second rule of the plant facility provision relates to the construction, reconstruction, or erection of a plant facility which was commenced before April 19, 1969. Under this rule, if pursuant to a plan of a taxpayer in existence on April 18, 1969, the taxpayer constructed, reconstructed, or erected a plant facility, and the construction, etc., was commenced before April 19, 1969, then all property of the type which is generally eligible for the investment credit which makes up the facility is to continue to be eligible for the credit. For this purpose, construction, etc., of a plant facility is not to be considered to have commenced until it has commenced at the site of the plant facility. (This latter rule does not apply if the facility is not to be located on land and, therefore, where the initial work on the facility must begin elsewhere.) In this case, as in the case of the commencement of construction of a building, construction begins only when actual work at the site commences; for example, when work commences on the excavation for footings, etc., or pouring the pads for the facility, or the driving of foundation pilings into the ground. Preliminary work, such as clearing a site, test drilling to determine soil condition, or excavation to change the contour of the land (as distinguished from excavation for footings), does not constitute the beginning of construction, reconstruction or erection.

The committee amendments add a provision to this rule which extends it to the case where the site of a plant facility was acquired before April 19, 1969, for the purpose of constructing a refinery and substantial expenditures were incurred for the acquisition of the right to use one or more pipelines in connection with the refinery before April 19, 1969. The provision stipulates in such a case that if the taxpayer begins to construct or erect the refinery within one year from the date of acquisition of the site for the refinery, the date on which the site was acquired is to be treated as the date on which the construction of the refinery began for the purposes of this provision.

The plant facility provision contains a special rule applicable where a certificate of convenience and necessity has been issued to a taxpayer before April 19, 1969, by a Federal regulatory agency. The special rule applies where the certificate is applicable to two or more plant facilities which are included under a single plan of the taxpayer to construct, reconstruct, erect or acquire the plant facilities and more than 50 percent of the aggregate basis of all of the depreciable property making up the facilities is attributable either (i) to property, the construction, reconstruction, erection of which was begun before

April 19, 1969, or (ii) property, the acquisition of which occurred before that date. In such a case, the plant facilities are to be treated as a single plant facility and will not be subject to the repeal of the investment credit.

(*vii*) *Machinery and equipment rule.*—The general rule as to what constitutes construction (reconstruction or erection) of machinery and equipment has been discussed above (see (*i*) above). Similarly, where binding contracts have been entered into before April 19, 1969, the rules for machinery and equipment generally applicable have also been discussed above (see (*iv*) above). In general, these rules provide that the construction begins when the production or assembly commences. In addition, the investment credit is also available with respect to machinery and equipment covered by a binding contract entered into before April 19, 1969. Under these rules, however, only the specific equipment and machinery commenced or ordered under a binding contract are eligible for the investment credit.

The two versions of the bill also contain a provision that deals with machinery and equipment which was only partially on order, or under construction, on April 18, 1969. Under this rule the investment credit will continue to be available with respect to any machinery or equipment, more than 50 percent of the parts or components of which were on hand on April 18, 1969, or are acquired pursuant to a binding contract which was in effect on that date.

The parts and components which are on hand or on order (under a binding contract) on April 18 must be held for, or have been ordered for, use in the machinery or equipment. This 50-percent requirement is to be determined on the basis of cost, and for the rule to apply, the cost of the parts and components must not be an insignificant portion of the total cost of the item of machinery or equipment.

Thus, for example, if there were a binding order on April 18, 1969, for the acquisition of the frame of an airplane, parts and components necessary for the airplane to become a functioning unit would also be eligible for the investment credit (even though not on order at that time) if these remaining parts and components did not account for 50 percent or more of the total cost of all the parts and components of the airplane. Accordingly, if the motors, galley, seats, navigation, and radio equipment and necessary spare parts acquired at the time the plane is put into operation had not been ordered before April 19, but constituted less than 50 percent of the total cost of the plane, the investment credit will be available not only with respect to the airframe but also with respect to this machinery and equipment as well.

This special rule is applicable to machinery and equipment wholly apart from any application the equipped building rule or the plant facility rule (explained above) may have because of the interrelationship of the machinery and equipment with a building and plant facility. However, a piece of machinery or equipment which continues to receive the investment credit under this rule is to be included in determining whether the equipped building or plant facility, of which it is a part, meets the 50-percent requirement of the equipped building or plant facility provisions.

(*viii*) *Certain leaseback transactions.*—It is common practice for a business to enter into binding contracts for the purchase of machinery and equipment used in its trade or business wherein the machinery and equipment is sold to a third person but leased back by the person initially ordering the property. In such cases the person entering into the purchase contract initially is committed to purchase the article. For that reason both versions of the bill provide that where binding contracts have been entered into on or before April 18, 1969, and the property involved is transferred to a third party, the property is to be eligible for the investment credit, despite the repeal provided by the bill, if certain conditions are met.

The committee's attention was called to the fact that a person holding property which qualifies for the credit under the machinery and equipment rule, rather than under the binding contract rule, also may wish to sell the property to a third party and to lease it back. The committee believes that the leaseback rule also should be applicable in this case. In each situation, the person who wishes to sell the property and lease it back is substantially committed as of April 18, 1969, to the acquisition or construction of the property. Accordingly, the committee amendments extend the leaseback rule in the House bill to situations where the property which is sold and leased back is eligible for the investment credit in the seller's hands under the machinery and equipment rule. The committee amendments also modify the House provision to permit property to be leased back by a corporation which is a member of the same affiliated group as the person who transfers the property to the lessor in certain situations.

The bill provides that when a person who is a party to a binding contract transfers his rights in the contract (or the property covered by the contract) to another person and a party to the contract retains a right to use the property under a lease, then to the extent of the transferred rights, this other person is to succeed to the position of the transferor with respect to the binding contract and the property. For purposes of applying this rule, the committee amendments provide that a person who holds property for which a credit continues to be available by reason of the machinery and equipment rule is to be treated as having had a pre-April 18, 1969, binding contract for the property. Thus, this type of property also may be transferred to another person who will succeed to the position of the transferor with respect to the property, if the transferor retains a right to use the property under a lease.

In determining whether a party to the contract retains a right to use the property under a lease (either where the property was subject to a pre-April 19, 1969, binding contract or where the property qualifies under the machinery and equipment rule), the committee amendments provide that a corporation which is a member of the same affiliated group as the person transferring the property is to be treated as the transferor and as a party to the contract if simultaneously with the transfer of the property to another person the corporation acquires a right to use the property under a lease with the other person.

The lease may be for any term unless the lessor decides not to exercise his statutory election to permit the lessee to claim the investment credit, in which case the lease must be for a term of at least 1 year. In the House bill it was provided that, if the lessee subsequently lost the right to use the property, such as by returning it to the lessor upon termination of the lease, this would be treated as a disposition of the property by the lessor which would bring into play the rules which cause a recapture of the investment credit previously allowed with respect to property where it is disposed of prior to the end of the useful life of the property used in determining the amount of credit allowed.

The leaseback rule which was provided by Congress in 1966 in connection with the suspension of the investment credit did not contain this recapture rule. Instead, it was provided that where the lessor retained the credit, the lease must be a long-term lease. The purpose of both rules is to insure that the lessee, in effect, receives the benefit of the investment credit by preventing the lessor from unilaterally taking the property back and leasing to another person at a higher rental. The committee believes this purpose is adequately served where the lease is for a long term, since in this case the lessor may not unilaterally take the property back prior to the expiration of the lease. Accordingly, the committee amendments restrict the application of the recapture rule to situations which do not involve a long-term lease. In other words, the recapture rule is to continue to apply where the lessor does not elect to pass the credit through to the lessee and the lease is not for a long term, but is not to apply if a long-term lease is involved. A lease is to be considered a long-term lease either if it is for a term which is substantial in relation to the estimated useful life of the leased property or if it is for a term of 8 years or more.

For purposes of applying the recapture rule in situations which do not involve a long-term lease, a lessee would not be treated as losing his right to use the property if he transferred the lease in a transfer of the type which is to be disregarded in determining whether the investment credit is available (see (*x*) below), such as a transfer by reason of death, so long as the person to whom the lease is transferred retains the right to use the property. A lessee also would not be treated as losing his right to use the property where he subleases the property unless the sublease is in effect a sham transaction. In other words, if the lessee normally would have returned the property to the lessor and the lessor then would have leased the property to another person, but instead the lessor and lessee, in effect, arrange to accomplish the same results by means of a sublease, the subleasing will be treated as a disposition of the property by the lessor.

The provision described above is not applicable where the election was made and the credit passed on to the lessee, because in those cases the recapture provisions automatically come into play if the lessee's right to use the leased property terminates before the expiration of the period on which the investment credit originally is based. The rule provided in this provision also covers the case where a person obligated under a pre-April 19 binding contract is only one of two or more joint lessees under the leaseback arrangement.

The types of arrangements which are covered by this provision include:

(*a*) cases where the user of the machinery and equipment has a binding contract to purchase machinery and equipment on April 18, 1969, and subsequently transfers the contract to purchase the property to a third party from whom the user leases back the right to use the property;

(*b*) cases where, under a contract binding on April 18, 1969, to purchase machinery and equipment, a business obtains delivery of the property, immediately transfers the property (before using it) to a third party, and leases the property back;

(*c*) cases where a builder of equipment transfers equipment (before using it) which qualifies for the credit under the machinery and equipment rule to a third party and, simultaneously with the transfer, a corporation which is affiliated with the builder leases the property from the third person;

(*d*) cases where a builder or supplier of machinery and equipment entered into a lease arrangement with a business before April 19, 1969, and subsequent to that time sells the property involved to a third person subject to the lease arrangement referred to.

In the first three illustrations above, the investment credit is available because the third party (by succeeding to the position of the user, the business, and the builder, respectively) is treated as having acquired property pursuant to a contract which was binding on him as of April 18, 1969. (See (*iv*) above.) In the fourth illustration, the credit is available because the third person (by succeeding to the position of the builder or supplier) is treated as having constructed the property pursuant to a binding contract to lease in effect on April 18, 1969. Under the exception for property constructed pursuant to certain leases (discussed in (*ix*) below), property so constructed is eligible for the investment credit.

(*ix*) *Certain leases involving third parties.*—Both versions of the bill also provide for certain situations where binding contracts or leases have been entered into between parties prior to April 19, 1969, which require the construction or acquisition of machinery and equipment under the terms of the lease or contract arrangements, even though the situations do not involve a binding contract of the type described earlier between the person who will use the property and the person who will construct or supply it.

Under the two versions of the bill, where a binding lease or contract is in effect on April 18, 1969, under which the lessor or lessee (or both) is obligated to construct (reconstruct or erect) or acquire machinery and equipment which is specified in the lease or contract, then the investment credit is to continue to be available with respect to any property constructed under the lease or contract. The committee amendments also provide that this rule is to be applicable where the property is specified in documents related to the lease contract or contract to lease, if the documents were filed with a Federal regulatory agency before April 19, 1969; or where the specifications of the property are readily ascertainable from the terms of the lease or contract to lease, or from the related document. In cases where a project includes property in addition to that covered by a specific lease arrangement, this provision is to apply to the other property only if binding leases and contracts in effect on April 18, 1969, covered real property representing at least a quarter of the entire project. (This is to be determined on the basis of the rental value of the different parts of the project.) This limitation is designed to prevent a large project from being covered merely because of minor or incidental lease agreements in effect on April 18, 1969. As indicated previously, this provision applies to sales contracts as well as lease contracts.

The types of cases covered by this provision include, for example, a situation where a builder of a shopping center may have entered into a lease agreement with a tenant for a major store building in a shopping center before April 19, 1969, and in connection with this lease agreement the builder agrees to build a specified number of shopping center units. In exchange for this agreement, the major store tenant agrees to equip and operate the store to be leased to him. In other cases, parties may have agreed to construct and lease industrial plants to businesses and in exchange the businesses agree to equip the plants with machinery and equipment necessary for the businesses, either directly or under a sale and leaseback arrangement.

Where a company enters into a long-term lease with an industrial development board to lease a plant the construction and equipping of which is financed through the sale of industrial development bonds, the transaction may not be considered for some tax purposes as a lease, but instead may be considered for depreciation and investment credit purposes as a financing transaction in which the company is treated as the owner. Nevertheless, it is intended under the investment credit termination rules that the transaction be treated as a lease and that such property be treated as pre-termination property in the hands of the lessee as owner.

Where the bill provides that the property to be provided must be specified in the lease or contract, this is not intended to preclude the property being specified in a separate document of which both parties were fully aware at the time of the lease or contract agreement. Nor is it required that all of the property be specified in detail at that time so long as the general types and amount of property are fairly determinable at the time the lease or contract is entered into.

The two versions of the bill also provide a modification of the rules set forth above in the case of a binding contract or contracts entered into before April 19, 1969, involving the construction, etc., or acquisition of property specified in an order of a Federal regulatory agency for which an application was filed before April 19, 1969. In such cases if the property is to be used to transport one or more products to be purchased or sold under the contract or contracts, the investment credit is to continue to be available for the property if one or more parties to the contract or contracts have contractual commitments in existence on April 18, 1969, which in the aggregate require the taking or providing of more than 50 percent of the products to be transported over a substantial portion of the expected useful life of the property.

An example of the type of case covered by this provision would be a situation where a company has entered into a binding contract to buy or sell fuel and is required to construct a new pipeline or add capacity through an existing pipeline in order to transport such fuel. The provision would be applicable in this situation, however, only if one of the parties to the purchase or sale contract or contracts has contractual commitments in existence on April 18, 1969, which in the aggregate require such person to take or provide more than 50 percent of the fuel to be transported through such pipeline over a substantial portion of the useful life of the new construction, and if the new construction is specified in an order of a Federal regulatory agency for which application was made before April 19, 1969.

The committee amendments also contain a provision, which was not contained in House bill, dealing with a similar type of situation that is in large part identical to a transition rule approved by Congress in 1966 in connection with the suspension of the investment credit. This provision covers situations where a taxpayer must construct (or reconstruct) or acquire property to carry out a pre-April 19, 1969, binding contract and either the property is specified in the contract or it is a contract for the extraction of minerals and a number of prescribed conditions are satisfied. In these cases the investment credit is to continue to be available for the property if it is to be used to produce one or more products under the contract and if the other party to the contract is required to take substantially all the products to be produced from the property for a substantial portion of its estimated useful life (or is a State or political subdivision which is required to make substantial expenditures which benefit the taxpayer).

As indicated, this provision may be applicable in the case of a contract for the extraction of minerals even though the property is not actually specified in the contract if a series of conditions are satisfied. The committee amendments require that the mineral properties from which the minerals are to be extracted must be specified in the binding contract and the specifications for the property which the taxpayer needs to perform the contract must be readily ascertainable from the location and characteristics of these mineral properties. Moreover, the property must be original, not replacement, property and must be necessary for, and used solely in, the extraction of minerals under the binding contract. It also is required that the binding contract must be a fixed price contract (although it may provide for price changes except with respect to the loss of the investment credit). In order for property to qualify under this provision, the taxpayer must have begun construction of it, or acquired it, prior to April 19, 1970 (or pursuant to a pre-April 19, 1970, binding contract), and the property must be placed in service prior to 1973.

An example of the type of case covered by this provision would be a situation where a person is obligated under the terms of the contract to build an industrial gas plant which is specified in the contract for the purpose of supplying the industrial gas to a steel or chemical company. Another example of a type of case covered by this provision would be a situation where a coal company must acquire equipment (including items such as a bulldozer which removes overburden) in order to carry out a binding contract under which the company is obligated to open new coal mines on specified mineral properties and to sell the coal to utilities at prices fixed in the contract.

(*x*) *Rules where property is transferred at death, etc.*—The two versions of the bill provide that in determining whether property is to be treated as if acquired or under binding contract before April 19, 1969 (and therefore is eligible for the investment credit), certain transfers are to be disregarded. These are cases where it seems appropriate for the transferee "to step into the shoes" of the transferor.

The first transfer where the transferee is treated the same as the transferor is a transfer by reason of death. Under this provision, property (or a contract to purchase property) with respect to which the investment credit would be available in the hands of the decedent continues to be eligible for the investment credit in the hands of the person who acquires the property from the decedent.

The same treatment is also applied to certain specified transfers in which the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor. The specified transfers are—

(*a*) transfers to a corporation upon the liquidation of a subsidiary (sec. 332 of the code),

(*b*) transfers to a controlled corporation (sec. 351 of the code),

(*c*) transfers pursuant to corporate reorganizations (secs. 361, 371(a), and 374(a) of the code),

(*d*) transfers of property to a partnership by a partner in exchange for an interest in the partnership (sec. 721 of the code), and

(*e*) transfers by a partnership to a partner (sec. 731 of the code).

In addition, where under a special provision of the code (sec. 334(b) (2)) the acquisition by a corporation of the stock of another corporation and the liquidation of the acquired corporation are treated as the purchase of the assets of the liquidated corporation for purposes of computing the basis of the assets acquired, the transfer of the assets is to be disregarded in determining whether the credit is to be available if the stock of the distributing corporation was either acquired before April 19, 1969, or pursuant to a binding contract to acquire the stock which was in effect on April 18, 1969, or both.

The committee amendments also include a type of transfer, which was not provided for in the House bill, among the transfers to be disregarded in determining whether the credit is available; namely, where substantially all of the assets of a corporation are purchased pursuant to a pre-April 19, 1969, contract which is binding on the purchaser. This eliminates the disparity in treatment under the House provision between a direct purchase of a corporation's assets pursuant to a pre-April 19, 1969, binding contract and an indirect purchase of the corporation's assets (i.e., the acquisition of the stock of the corporation pursuant to such a binding contract and the subsequent liquidation of the corporation under sec. 334(b) (2)).

(*xi*) *Property acquired from affiliated corporations*.—It is a common practice in some affiliated groups of corporations for the group to do its purchasing outside the group through one of the corporations which is a member of the group. In these situations the committee agrees with the House that acquisitions by, and binding contracts of, the purchasing member of the group should be considered as acquisitions by, or contracts of, the corporation for which they are made, for purposes of the bill. For this reason the two versions of the bill provide that property acquired by a corporation which is a member of an affiliated group for another member of the same group is to be treated as having been acquired by the other member on the date it was acquired by the purchasing corporation; and that where a binding contract for the construction, reconstruction, erection, or acquisition of property has been entered into by the one member of a group, the corporation on whose behalf the contract was made is to be treated as having entered into the contract on the date on which it was entered into by the other member.

In addition, the corporation is to be treated as having commenced construction, and so forth, of any property on the date on which another member commenced construction, and so forth.

In cases where an affiliated group of corporations files a consolidated return, the committee agrees with the House that similar treatment should be accorded to intragroup transfers of property or contracts. It is the committee's understanding that this treatment would be consistent with that generally provided under the consolidated return regulations. Accordingly, the House and the committee contemplate that under the consolidated return regulations in the case of intragroup transfers of property or contract rights during a year in which consolidated returns are filed, other than section 334(b)(2) transactions, the transferee member is to stand in the shoes of the transferor member for purposes of determining whether property continues to be eligible for the investment credit.

The House bill also provided that a contract between members of an affiliated group is not to be treated as a binding contract, insofar as such members are concerned (for purposes of the binding contract rule, the other transition rules, and the provision disallowing the investment credit in certain situations involving leased property, see (*xiv*) below). The committee retained this provision of the House bill but amended it to provide for certain cases where one or more members of an affiliated group have disaffiliated. The type of situation with which the committee was concerned is where corporations which were members of the same affiliated group entered into a binding contract with each other before April 19, 1969, but by June 30, 1969, and prior to the completion of performance of the contract the corporations no longer are members of the same affiliated group. The committee amendments make the rule inapplicable in these cases and thus the contract is to be treated as a binding contract.

Generally, although a contract between members of an affiliated group may be legally binding, it is not binding as a practical matter. It is not intended that, because the bill deals expressly with contracts between two members of an affiliated group while remaining silent as to other contracts between related parties, any inference is to be made that any other contracts which are not binding because of the relationship of the parties are to be treated as binding for purposes of the bill.

(*xii*) *Barges for ocean-going vessels.*—Another type of situation covered by the two versions of the bill is where property is constructed pursuant to a binding contract in effect on April 18, 1969, even though it is not a binding contract between the person who will use the property and the person who will construct it. This situation involves barges for use on ocean-going vessels in certain situations where the vessels were under a binding contract on April 18, 1969, but the barges had not been ordered by that time. In essence these are situations where the ocean-going vessel, the so-called mother ship, and the barges it is designed to carry are complementary parts of a total ship. Although the mother ship otherwise would be eligible for the investment credit (pursuant to the binding contract rule), the barges which, in effect, are an integral part of that ship would not otherwise be eligible for the credit.

It is contemplated in this type of situation that a greater number of barges than can be carried at one time on a mothership will be associated and used with the mothership. This is because at any given time some barges will be on the ship in transit, while other barges will be in port being loaded or unloaded. It is the committee's understanding that the House intended to continue to allow the credit for the number of barges intended to be used in connection with the mothership, even though that number was greater than the number of barges which could be carried on the mothership at any one time. In the House provision, however, the number of barges for which a credit was to continue to be available was inadvertently restricted to the number which may be carried on the mothership. It also was called to the committee's attention that the House provision applied only to subsidized carriers. The committee does not believe that unsubsidized carriers should be denied the benefit of this transition rule in situations where there was a similar substantial degree of commitment to the total project on April 18, 1969.

The committee amendments therefore provide that the investment credit is to continue to be available for barges which are specifically designed and constructed or acquired for use with ocean-going vessels which are designed to carry barges if the credit continues to be available for the vessels (pursuant to the binding contract rule or other transition rule). The number of barges to which this provision applies, however, is subject to one of two alternative limitations. The first limitation is the number of barges specified in an application for mortgage or construction loan insurance filed under title XI of the Merchant Marine Act, 1936, with the Secretary of Commerce provided the application was filed prior to April 19, 1969. Under this limitation it is only required that the prescribed application specifying the number of barges to be used in connection with the motherships have been filed prior to April 19, 1969. The fact that the application was approved in whole or in part before or after April 19, 1969, would not be relevant in determining the number of barges which may qualify under this provision.

If the above described limitation does not apply because the specified application was not filed, then the number of barges for which an investment credit is to continue to be available is to be limited to the number which the taxpayer establishes as necessary to the initial planned use of the mothership provided that more than 50 percent of that number of barges otherwise are eligible for the credit (under the binding contract rule or other transition rule).

The investment credit also is to be allowable under this provision for any machinery and equipment which is to be installed in the barges covered by the provision if the machinery and equipment is necessary for the planned use of the barges.

(*xiii*) *Certain new design products.*—Cases have arisen which involve situations where taxpayers had undertaken a project to produce products of a new design pursuant to binding contracts which had been entered into prior to April 19, 1969. In order for the party undertaking the project to continue it, it is necessary for that party to obtain or construct certain machinery and equipment. The House bill and the committee amendments, in effect, provide that the investment credit is to be allowable with respect to the machinery and equipment (if it is placed in service before 1972) in these situations, generally, if a significant portion of the project was completed or committed prior to April 19, 1969.

The committee amendments differ in two minor respects (noted below) from the provision which was included in the House bill. The committee's attention was called to a situation where two competing taxpayers are committed to substantially the same degree to projects to produce competing products, but because of minor differences between the binding contracts to sell the new design products in the two cases only one of the taxpayers would be covered by the House provisions. The committee believes that these taxpayers should be similarly treated and that the investment credit should continue to be equally available.

Specifically, the committee amendments cover situations where a taxpayer had undertaken prior to April 19, 1969, a project to produce a product of a new design purusant to binding contracts in effect prior to that date, if the binding contracts were fixed price contracts. The committee amendments provide that the contracts may contain provisions which require or permit price changes resulting from changes in rates of pay or cost of materials. (The House provision was limited to price changes with respect to changes in rates of pay.) The permitted price change provisions would include a provision under which the adjustment in the price of the product is determined with reference to relevant statistical indexes. Under the committee amendments it also is required that the binding contracts cover more than 50 percent (60 percent under the House provision) of the entire production of the newly designed product to be delivered prior to 1973. In addition, this provision is applicable only where prior to April 19, 1969, more than 50 percent of all depreciable property (determined on the basis of the aggregate adjusted basis of the property) required to be constructed (reconstructed or erected) or acquired to carry out the binding contracts either was under construction (reconstruction or erection) by the taxpayer, had been acquired by the taxpayer, or was under a binding contract for construction or acquisition. In applying this 50-percent test, certain productive items (jigs, dies, templates, and similar items) which are specifically designed for, and are only suitable for use in, the manufacture or assembly of the newly designed product under the project are to be considered as property which was under a binding contract for construction on April 18, 1969, if these items were described in written engineering and internal financial plans of the taxpayer in existence on that date. It is sufficient for this purpose that the plans of the taxpayer generally describe the productive items.

In situations where the conditions described above are met, the investment credit is to be available with respect to the tangible personal property which is required to carry out the binding contracts pursuant to which the project had been undertaken to the extent the property is placed in service by the taxpayer prior to 1972.

The newly designed product which is the subject of the project undertaken by the taxpayor must, in fact, be a product which is substantially changed from products previously produced by the taxpayer. In other words, a product will not be considered to be of a new design if it is basically merely a new model of a product previously produced by the taxpayer. For example, a project by an airplane manufacturer to produce a new model of an existing commercial airplane produced by the taxpayer, which new model had only a somewhat larger passenger carrying capacity and a moderately longer range than the existing model, would not be considered a project to produce a product of a new design. On the other hand, an airplane designed for commercial use would be considered a product of a new design if it had a substantially greater carrying capacity than the existing models of commercial planes produced by the taxpayer.

(*xiv*) *Certain leased property.*—The two versions of the bill provide, in effect, that the investment credit is not to be allowed in certain situations involving leased property where it is likely that the lessor has changed his usual manner of doing business primarily to obtain the benefits of an investment credit which otherwise would be disallowed.

Specifically, both versions of the bill provide that in the situations where—

(i) property is leased after April 18, 1969 (other than pursuant to a binding contract to lease entered into before April 19, 1969),

(ii) the property is eligible for the credit in the hands of the lessor but would not be eligible for the credit if acquired by the lessee, and

(iii) the property is of the same kind which the lessor ordinarily sold to customers before April 19, 1969, or ordinarily leased and passed the credit through to the lessee before that time,

then neither the lessor nor the lessee may receive an investment credit with respect to the property.

In these situations, if the lessor had continued his usual manner of doing business, the leased property would not have been eligible for the credit since it would have been acquired by the purchaser or the lessee after April 18, 1969. It appears, however, that the lessor by changing his method of doing business could (in the absence of this provision) obtain the benefits of a credit because the property either had been acquired by him before the repeal date or is, in effect, treated as having been so acquired under the binding contract rule or another transition rule.

(*xv*) *Rules relating to certain casualties and thefts and to the replacement of certain section 38 property.*—Present law provides for the recapture of the investment credit where property with respect to which the credit was allowed is disposed of prior to the end of the period (that is, 4–6, 6–8, or 8 or more years) which was used in determining the amount of the credit originally allowed. Where the property disposed of is replaced by other property which is eligible for the investment credit, however, the effect of present law in allowing a credit for the replacement property is to reduce or eliminate the recapture of the credit with respect to the property disposed of. In other words, the credit allowed on the replacement property offsets the credit recaptured with respect to the property disposed of.

The committee believes that essentially the same treatment should be allowed to continue after the repeal of the investment credit where the replacement property is similar or related in use to the property disposed of. Accordingly, the committee amendments provide that where property with respect to which an investment credit was obtained is disposed of and is replaced by property (that would be eligible for the investment credit if the credit had not been repealed), then, in effect the amount of the credit recaptured with respect to the property disposed of is to be reduced (but not below zero) by the amount of the credit which would have been allowed (in the absence of the repeal) for the replacement property. In order for this rule to apply, the replacement property must be placed in service by the taxpayer within 6 months after the time the property which it replaces is disposed of.

Present law also contains special rules with regard to the recapture of the credit where property is stolen, or damaged or destroyed by casualty (referred to here as "casualty property"). Where the casualty property is replaced by property which is eligible for the investment credit, these rules basically have the effect of preserving the investment credit with respect to the casualty property.

The committee amendments continue essentially the same treatment by providing that the replacement rules described above (other than the 6-month requirement) also are to apply to casualty property where the casualty occurs before April 19, 1969. Where the casualty occurs after April 18, 1969 it is provided that the recapture rules are not to apply to the casualty property.

In the case of casualty property, a provision was included in the House bill which was intended to achieve substantially the same effect as the committee amendments.

(*xvi*) *Interest and penalties.*—The committee amendments include provisions regarding the payment of interest on an underpayment of tax and regarding payments of, and penalties for underpayments of, estimated tax which results from the repeal of the investment credit. Similar provisions were not included in the House bill.

First, the committee amendments provide that to the extent an underpayment of tax for a taxable year ending before the enactment of the bill is attributable to the repeal of the investment credit, interest on the underpayment is not to start running until the 90th day after enactment of the repeal. In other words, taxpayers whose taxable years end before the enactment of the bill and who pay any underpayment of tax which is attributable to the repeal of the investment credit within 90 days after enactment will not incur interest on the underpayment.

Second, the committee amendments provide that a taxpayer who must increase his estimated tax payments to take the repeal of the investment credit into account is to pay the additional amount of estimated tax ratably over the remaining installments for his taxable year, beginning with the first installment which is due on or after 30 days after the enactment of the bill. In other words, the effect of the repeal of the credit on the estimated tax for the entire taxable year is to be taken into account in determining payments required to be made on the remaining installment dates in order for the taxpayer to avoid penalty for underpayment of estimated tax.

Taxpayers, however, are not to be subject to a penalty for underpayment of the estimated tax for any period prior to the date of the first installment occurring 30 days or more after the enactment of the bill if they would not have been subject to a penalty under existing law. In other words, the amendments made by the bill are not to be taken into account in determining the applicability of a penalty for under payment of estimated tax due prior to the 30th day after enactment of the bill.

Revenue effect.—It is anticipated that the revenue effect of repealing the investment tax credit will be an increase in receipts of $1.35 billion in fiscal year 1970, with $930 million attributable to corporation income tax and $420 million to the individual income tax. In fiscal year 1971, the repeal is expected to increase receipts by $2.5 billion, with $1.9 billion attributable to the corporation income tax and $0.6 billion to the individual income tax.

The full revenue effect from the repeal of the investment tax credit is estimated at $3.3 billion.

W. AMORTIZATION OF POLLUTION CONTROL FACILITIES

(Sec. 704 of the bill and sec. 169 of the code)

Present law.—Under present law a taxpayer may claim an investment credit with respect to pollution control facilities to the extent they involve property of a type for which the investment credit generally is available.

General reasons for provision.—The committee recognizes that an important challenge facing our Nation today is the problem of environmental pollution. Our rivers, lakes, streams, and air are becoming increasingly polluted. Moreover, this is a problem which affects both the rural sections of our country and also our urban complexes. Industrial and human wastes and sewage are increasingly contaminating our rivers, and our air is being increasingly polluted by industrial contaminants.

Congress has addressed itself to the air and water pollution problem in legislation which it has passed in recent years. This legislation has laid a foundation for dealing with the pollution problem. In order to deal effectively with the Nation's air and water pollution problem, however, a significant part of the task must be met by private industry. In effect, private industry is being asked to make an investment which in part is for the benefit of the general public. Moreover, it also has been estimated that existing factories which attempt to curb pollution efficiently through the addition of antipollution equipment may face significant increases in capital costs. Moreover, expenditures for pollution control equipment generally do not result in any increase in the profitability of a plant.

At the present time companies which install antipollution equipment involving property of a type for which the investment credit is available receive, in effect, an incentive through the investment credit for dealing with the pollution problem. The repeal of the investment credit in this regard could have an undesirable effect on the efforts made by private industry to combat the pollution problem were another type of incentive not made available.

In view of the possible undesired effect on pollution control of repealing the investment credit and the increasing magnitude of the air and water pollution problem facing the Nation today, the committee agrees with the House that it is appropriate to provide an incentive to private industry for antipollution efforts. It also believes it is more appropriate to permit the rapid recovery of the costs involved, rather than to permit a return in excess of total costs. The House bill provided that the cost of new pollution control facilities (which are appropriately certified by the relevant State and Federal authorities) may be amortized over a 5-year period. Since quite often these facilities have a useful life of 10 to 20 years or more, the usual depreciation deduction each year is relatively small. The larger deduction provided by allowing the recovery of the taxpayer's cost over the shorter 5-year period would provide a greater incentive for the installation of effective pollution control equipment.

The committee has continued the concept of the amortization incentive provided in the House bill but has modified the House provision to limit its application to those situations where there is the greatest need for incentive. Since the cost of modifying an existing plant for pollution control purposes generally is substantially in excess of the cost of incorporating pollution control facilities into a new plant, the committee has limited the scope of the amortization deduction to facilities which are added to the existing plants. In addition, the committee has provided that only the part of the cost of the facility which is attributable to the first 15 years of its useful life may be amortized under this provision. The allowance of a 5-year writeoff for the full cost of long-lived assets would provide an unduly large stimulus to the purchase of these assets vis-a-vis shorter-lived assets.

The committee recognizes that the incentive provided in the bill is not a complete answer to the pollution problem. The need for broader and more effective pollution control standards remains. The amortization deduction provided by the bill, however, should be a useful component of the Nation's total efforts to deal with the pollution problem. It will ease the impact on private industry of the additional costs which it must incur for pollution control facilities and, thus, should encourage private industry to cooperate in the required efforts.

Explanation of provision.—Under both versions of the bill, a taxpayer (including an estate or trust) is to be allowed, at his election (under regulations prescribed by the Treasury Department) to amortize a certified pollution control facility over a period of 60 months. The committee amendments also limit the amortization deduction to pollution control facilities added to plants (or other properties) which were in operation before January 1, 1969. Thus, the special amortization provision is not to be available in the case of facilities included in new plants built in the future. The committee amendments further limit the 5-year amortization deduction by allowing it only for the proportion of the cost of the property attributable to the first 15 years of its normal useful life. Where a property has a normal useful life of more than 15 years, the taxpayer would in effect treat his facility as if it were two separate facilities. One facility (representing the portion of the total cost attributable to the first 15 years of useful life) would be eligible for the 5-year amortization. The other facility (the remaining cost) would receive regular depreciation based upon the entire normal useful life of the property. If the property has a normal useful life of 15 years or less, the total cost of the property would be eligible for the 5-year amortization.

The 60-month amortization period with respect to a facility is to begin either with the month after that in which the facility was completed or acquired, or with the next year, whichever the taxpayer elects. The amortization deduction for any month would be in place of the regular depreciation deduction which would be allowable for that month (under section 167) with respect to the portion of the facility eligible for amortization. A taxpayer who elected the amortization deduction with respect to a facility, however, would still be eligible to receive the additional first-year depreciation allowance (provided under section 179) with respect to that facility. However, no investment credit is to be available for that portion of any facility with respect to which the 5-year amortization deduction had been elected.

If the assets of a corporation are acquired by another corporation in a transaction subject to section 381 (which provides for the carryover of certain items in the case of certain corporate acquisitions), the acquiring corporation is to be treated for purposes of this provision, as if it were the acquired corporation.

The amortization deduction is to be available only with respect to a "certified pollution control facility," which generally is defined as depreciable property which is a separate identifiable treatment facility used to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, or storing of pollutants, contaminants, wastes or heat, and which is appropriately certified. A building is not a pollution control facility unless it is exclusively a treatment facility. Thus, a pollution control facility does not include any facility which serves any function other than pollution abatement. Moreover, facilities which only diffuse pollution, as distinct from abating it, are not pollution control facilities. In other words, a pollution control facility is an installation which prevents or minimizes the direct release of pollutants into the air or water in the course of manufacturing operations. For example, a smokestack on a plant whose height was increased to disperse pollutants over a broader area would not be a pollution control facility while a device which is contained in a smokestack and actually abates the emission of pollutants is to be a pollution control facility. In addition, a facility that removes certain elements from fuel (for example, sulphur which would be released as a pollutant when the fuel is burned) would not be a pollution control facility.

The amortization deduction is to be avilable only with respect to a facility the construction (reconstruction or erection) of which is completed by the taxpayer after 1968, or which is acquired after 1968, if the original use of the property commences with the taxpayer after that time. Only that portion of the basis of property constructed (reconstructed or erected) by the taxpayer which is properly attributable to construction (reconstruction or erection) after 1968, is to be taken into account for purposes of the amortization deduction.

As indicated, the amortization deduction is to be available only with respect to a pollution control facility which is certified by the appropriate State and Federal authorities. In the case of water pollution, the State certifying authority means the State water pollution control agency as defined in the Federal Water Pollution Control Act, and the Federal certifying authority is the Secretary of the Interior. In the case of air pollution, the State authority is the air pollution control agency as defined in the Clean Air Act, and the Federal authority is the Secretary of Health, Education, and Welfare. An interstate agency authorized to act in place of a State certifying authority is to be treated as the certifying authority of the State.

Under the certification required by both versions of the bill, it would be necessary with respect to any pollution control facility for the State authority to certify to the Federal authority that the facility had been constructed (reconstructed or erected) or acquired in conformity with the State program or requirements regarding the abatement or control of water or air pollution or contamination. It would be further necessary for the Federal authority to certify to the Secretary of the Treasury with respect to any pollution control facility that the facility (1) was in compliance with the applicable regulations of Federal agencies, and (2) was in furtherance of the general policies of the United States for cooperation with the States in the prevention and abatement of water or air pollution under the Federal Water Pollution Control Act or the Clean Air Act, respectively.

The House bill also required the Federal authority to certify that the facility met minimum performance standards (which would be required to be promulgated by the Federal authority from time to time for this purpose and which would take technological advances into account and specify the appropriate tolerance of such pollutants and contaminants). The committee deleted this provision of the House bill in view of the fact that Congress previously has not granted the Federal Government authority to promulgate national standards of this nature. The committee believes it is appropriate to continue the past policy of allowing the States to set these standards within general guidelines established by the Federal Government.

Both versions of the bill further provide that the Federal certifying authority is not to certify any facility to the extent it appeared that the costs of the facility would be recovered over its actual useful life by reason of profits arising from the recovery of wastes or otherwise in the operation of the facility. This limitation is designed to insure that the incentive for controlling air and water pollution provided by the amortization deduction is not available in situations where it, in effect, would provide a windfall to taxpayers, i.e., where the cost of the facility is recovered through the sale of by-products derived from its operation.

With respect to property for which the amortization deduction provided by the bill has been elected, both versions of the bill further provide for the recapture (under section 1245) of the amortization deductions claimed with respect to property. In other words, to the extent of the previous amortization deductions, a gain arising on the disposition of a pollution control facility is to be treated as ordinary income.

The amortization deduction may be discontinued by a taxpayer at any time. If a taxpayer does discontinue the amortization deduction, then he may depreciate the property starting with the first month to which the amortization deduction is not applicable. A taxpayer who does discontinue the amortization deduction, however, would not be entitled to any further amortization deduction with respect to that facility.

Under the committee amendments (but not the House bill) the amortization deduction is to be available only for air or water pollution control facilities placed in service before January 1, 1975. This will provide the Congress with an opportunity to evaluate the effectiveness of the program in achieving its objective.

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Effective date.—The amendments made by this provision of the House bill and the committee amendments are to be applicable with respect to taxable years ending after December 31, 1968.

Revenue effect.—The revenue loss from this provision is estimated at $15 million in 1970, and it is estimated to rise to $115 million in 1974.

X. AMORTIZATION OF CERTAIN RAILROAD ROLLING STOCK, ETC.

(Secs. 705 and 706 of the bill and secs. 184, 185 and 263(e) of the code)

Present law.—Under present law, a taxpayer generally may claim an investment credit with respect to railroad rolling stock. Under present depreciation guidelines, the useful life of rolling stock is 14 years.

General reasons for change.—Since the enactment of the investment credit, the railroads have been able to increase their investment in new equipment and facilities to a considerable degree. The result has been a substantial contribution to modernizing railroad equipment, increasing railroad efficiency, reducing freight car shortages during seasonal periods of critical need, and improving the ability of railroads to finance acquisitions of new equipment.

Repeal of the investment credit may affect the ability of the railroads to continue their present investment programs at the same pace. Because of the importance to the economy of a healthy railroad industry and the existence of the present shortage of freight cars, the committee believes that an alternative form of incentive to encourage continuation of the present level of investment is needed. Moreover, it believes that it is more appropriate to permit a rapid recovery of the costs involved, rather than to permit a return of more than total costs.

Explanation of provision.—The House bill would have provided that a domestic common carrier railroad, subject to regulation by the Interstate Commerce Commission, could elect to amortize its rolling stock (other than locomotives) over a 7-year period. This treatment was to be available in the case of rolling stock acquired after July 31, 1969 (where its original use commenced with the taxpayer after that date). Rolling stock constructed by the taxpayer after that date also was to be eligible for the 7-year amortization provisions.

The committee amendments substitute a broader provision for the provision contained in the House bill. Instead of 7-year amortization of new rolling stock, and in lieu of any special exception from the repeal of the investment credit, the committee amendments provide for 5-year amortization of new rolling stock including locomotives. (New rolling stock is rolling stock the original use of which commences with the taxpayer after 1968.) This provision applies to rolling stock placed in service after January 1, 1970. In addition, new rolling stock placed in service during 1969 is to be eligible for 4-year amortization to the extent of any uncovered costs as of January 1, 1970.

It is also provided that the Secretary of the Treasury (with the assistance of the Secretary of Transportation) is to issue regulations indicating particular classes of cars or locomotives which are considered to be in short supply. Rolling stock in these specific classes of cars or locomotives which is placed in service after 1972 (or, if later, after thirty days subsequent to the final promulgation of the regulations) is not to be eligible for the 5-year amortization writeoff.

The 5-year (or 4-year) amortization referred to above is to be available with respect to the rolling stock of all domestic railroads, switching and terminal companies which are wholly owned by domestic railroads and companies (such as Trailer Train, Pacific Fruit Express and Fruit Growers Express) 95 percent or more of whose stock is owned by one or more railroads. The 5-year (but not the 4-year) amortization also is to be available to lessors to the extent that their rolling stock is leased to a domestic railroad or railroad company. In no event is either the 5-year (or 4-year) amortization provision to be available in the case of rolling stock owned and used by companies other than domestic railroads or rolling stock leased to companies other than domestic railroads.

Companies eligible for the amortization deduction may elect it on a unit basis and are not required to adopt it for all rolling stock placed in service within a given year.

In addition, for purposes of the amortization provision, property placed in service by a domestic railroad or railroad company at any time during 1970 is to be presumed to be placed in service on December 31, 1969. Thus, with respect to this property the amortization period is to commence in January 1970. In the case of rolling stock placed in service in subsequent years, it is provided that the taxpayer may elect to begin the amortization period at the time when the property is considered placed in service under a consistently followed method of accounting for acquisitions and retirements of property which prescribes a date when property is placed in service.

Where a unit of rolling stock is rehabilitated (rather than repaired) the committee amendments provide that the capital expenditure incurred with respect to the unit of rolling stock is to be treated as a separate unit of rolling stock for which the amortization deduction is to be available if such separate unit of rolling stock would otherwise qualify.

The 5-year amortization provision under the committee amendments is to apply to qualified rolling stock placed in service before January 1, 1975. This will give Congress an opportunity at that time to review this amortization provision to see what, if any, changes or modifications may then appear desirable.

In the absence of action to the contrary, the fact that railroad rolling stock was amortized rather than subject to depreciation (with a 14-year life) would have an adverse effect on the extent to which railroads were considered as meeting the so-called reserve ratio test under the present Treasury revenue procedure setting out the "guidelines" (Rev. Proc. 62–21). To overcome this adverse effect, it is understood that the Treasury Department for 1969 and later years will take into account, for reserve ratio purposes, the acquisitions of rolling stock with respect to which the amortization election has been made. In other words, the amortization base will be considered as if it were in the appropriate depreciation schedule (in the absence of amortization) and the guideline reserve ratio test will be applied by including in the depreciation reserve a simulated amount reflecting the accumulated depreciation on such equipment if it had been depreciated on the basis used by the taxpayer in its 1968 tax return.

It is further understood that to the extent the 5-year (or 4-year) amortization deductions result in larger deductions than would be available under the depreciation schedules previously in effect, the railroads are expected to maintain a level of investment in, or maintenance of, rolling stock and other transportation equipment equal to the level of these larger deductions. Thus, the larger deductions are being allowed on the basis that they represent a larger annual level of replacement of equipment necessary in order to sustain and improve railroad service to the public. The extent to which this level is achieved and maintained will be pertinent in deciding whether this provision should be extended at its expiration date on December 31, 1974.

This does not imply that there would be any specific tracing of funds or that the amount invested in transportation equipment need necessarily represent an increase over prior transportation equipment purchases but rather that railroads should, in general, attempt to see to it that their expenditures for purchases or maintenance of rolling stock and other transportation equipment would, over a period of years, at least equal the level of deductions obtained as a result of the amortization deductions.

Rolling stock which, because of acquisition or construction before April 19, 1969 or because of the binding contract or other transition rules, is eligible for the investment credit in 1969, 1970 or later years is nevertheless to be eligible for the 5-year (or 4-year) amortization deduction writeoff. The useful life of the rolling stock for purposes of the investment credit is to be determined on the basis of the rolling stock's actual useful life and is not to be based upon the 5- (or 4-) year amortization period over which it is written off.

Recently, upon audit by the Internal Revenue Service, questions have been raised as to the treatment of repairs in the case of railroad rolling stock. It has been contended by some agents that repair of the rolling stock represents a capital improvement extending the 14-year guideline life of the rolling stock. To prevent this result in the case of railroad rolling stock other than locomotives, the committee amendments will treat the cost of rehabilitation as an expense in all cases where such costs in any 12-month period do not exceed 20 percent of the unadjusted basis of the unit involved (i.e. the original cost of the unit when initially acquired by the taxpayer). This is not to be considered as a guideline, however, with respect to the repair of any other types of transportation equipment or in the case of other transportation companies or of other equipment generally. Nor will it constitute a limit on repair deductions for railroads; if amounts would otherwise be deductible as repairs, they will continue to be deductible even though the amount exceeds this limit.

The committee amendments also provide railroads with the option to amortize railroad gradings and tunnel bores on the basis of a 50-year average life. Under present law, railroads capitalize these costs but have not been able to depreciate them because of uncertainties as to the length of their useful life. The railroad property which would be amortizable includes only improvements resulting from excavating (including tunneling), constructing embankments, clearing, diverting of roads and streams, sodding of slopes, and all similar work necessary to provide, construct, reconstruct, alter, protect, improve, replace, or restore a roadbed or right-of-way for railroad track.

The investment to be amortized in this case is the adjusted basis for determining gain. If the property was acquired before 1913, its basis for this purpose will be its value as of March 1, 1913. This value will be the valuation made by the Interstate Commerce Commission or a comparable State regulatory body where appropriate. Either the railroad or the Internal Revenue Service may demonstrate that the March 1, 1913, value was different from such valuation, but the burden of proof will be on the party seeking to establish the different amount. Property purchased or constructed after February 28, 1913, would be amortized on the basis of the taxpayer's cost.

The amortization for railroad grading and tunnel bores is to begin with taxable years beginning on or after January 1, 1970.

Effective date.—The amendments made by this provision of the committee amendments are to apply to taxable years beginning after December 31, 1969.

Revenue effect.—It is estimated that this provision will cause a revenue loss of $125 million in 1970, and the loss will increase to $185 million by 1974. The revenue loss is estimated to decline after 1974 to $105 million by 1979 assuming Congress sees fit to extend the amortization provision beyond 1974.

Y. ADJUSTMENT OF TAX BURDEN FOR INDIVIDUALS

1. Increase in Standard Deduction (sec. 801 of the bill and sec. 141 of the code)

Present law.—Under present law, a taxpayer in computing taxable income may itemize his deductions or may take the larger of the minimum standard deduction or the 10 percent standard deduction. The minimum standard deduction is $200 plus $100 for each exemption, and the regular standard deduction is 10 percent of adjusted gross income. Both forms of the standard deduction are limited to $1,000 ($500 in the case of a married individual filing a separate return).

General reasons for change.—The 10 percent standard deduction was introduced in 1944 to reduce the complexity of the income tax for the vast majority of taxpayers. Instead of keeping records of deductible personal expenditures and itemizing deductions on their tax returns, more than 82 percent of taxpayers were able to use the simpler standard deduction when it was first introduced. Since that time, higher medical costs, higher interest rates, higher State and local taxes, increased homeownership, and more expensive homes have encouraged more and more taxpayers to itemize their deductions. In addition, itemization has been encouraged by rising incomes which have moved more and more taxpayers beyond the $10,000 income level where the $1,000 standard deduction ceiling first becomes applicable. The effect of higher incomes and increased expenses has been to decrease the proportion of returns using the standard deduction from 82 to 58 percent. As indicated in table 16 below, much of the decrease in the use of the standard deduction occurred before 1960.

TABLE 16.—PROPORTION OF INDIVIDUAL TAX RETURNS WITH STANDARD DEDUCTIONS, SELECTED YEARS SINCE 1944 AND ESTIMATED 1969: PRESENT LAW

Year	Total number of returns (millions)	Percent with itemized deductions	Percent with standard deductions
1944	47.1	17.8	82.2
1951	55.4	20.9	79.1
1955	58.3	29.0	71.0
1960	61.0	39.5	60.5
1963	63.9	43.9	56.1
1965	67.6	41.2	58.8
1969 (estimated)	75.7	41.8	58.2

Note: It should be noted that the lower percent with itemized deduction in 1965 was due to the introduction of the minimum standard deduction in 1964.

At the present time the standard deduction accounts for most of the returns filed for those with adjusted gross incomes below $3,000 and still accounts for three-fourths of the returns for adjusted gross income levels of $3,000 to $5,000. However, upon reaching the $7,000 to $10,000 adjusted gross income level the present standard deduction already accounts for less than half of the returns. For those with incomes between $10,000 and $15,000 the standard deduction accounts for only about one-fourth of the returns filed, and above that level it tails off quite rapidly, reaching a very small percentage in the $20,000 to $50,000 class. These data, by income classes, are shown in table 17 below.

TABLE 17.—ESTIMATED NUMBER AND PERCENTAGE OF TAXABLE AND NONTAXABLE ITEMIZED AND STANDARD DEDUCTION RETURNS, 1969 LEVELS

[Number of returns in thousands]

AGI class (thousands)	All returns	Standard deduction returns		Itemized deduction returns	
		Number	Percent	Number	Percent
0 to $3	21,318	19,756	92.7	1,562	7.3
$3 to $5	10,582	7,905	74.7	2,677	25.3
$5 to $7	10,006	6,064	60.6	3,942	39.4
$7 to $10	13,867	5,886	42.4	7,981	57.6
$10 to $15	13,087	3,638	27.8	9,448	72.2
$15 to $20	3,853	591	15.3	3,263	84.7
$20 to $50	2,600	226	8.7	2,374	91.3
$50 to $100	340	10	2.9	330	97.1
$100 and over	95	1	1.0	94	99.0
Total	75,748	44,077	58.2	31,671	41.8

Source: Treasury Department.

When the 10-percent standard deduction was first introduced, 10 percent was much closer to the average percentage of income represented by itemized deductions than is the case today—approximately 14 percent in 1944 and 18 percent in 1969. As table 18 shows, the percentage varies appreciably among income classes, ranging from over 20 percent in the under $7,000 adjusted gross income classes to slightly more than 14 percent in the $50,000–$100,000 adjusted gross income class.

TABLE 18.—*Itemized deductions as a percent of adjusted gross income on itemized returns, 1969*

AGI class (thousands):	Percent
0 to $3	40.0
$3 to $5	27.4
$5 to $7	21.9
$7 to $10	20.0
$10 to $15	17.7
$15 to $20	16.2
$20 to $50	14.6
$50 to $100	14.5
$100 and over	18.8
All classes	17.9

The committee agrees with the House that it is desirable to simplify substantially the preparation and auditing of individual income tax returns by increasing appreciably the number of taxpayers using the standard deduction. It believes that to the extent possible it is desirable to increase the percentage of all taxpayers using the standard deduction to a level approaching the 82 percent that used the standard deduction in 1944.

Explanation of provision.—Both the House bill and the committee amendments increase the present 10 percent standard deduction with a $1,000 ceiling to a 15 percent standard deduction with a $2,000 ceiling. Both versions of the bill provide that the standard deduction is to be 13 percent with a $1,400 ceiling in 1970, 14 percent with a $1,700 ceiling in 1971, and finally 15 percent with a $2,000 ceiling in 1972 and for subsequent years.

Nearly 34 million returns will benefit as a result of this increase in the standard deduction. This constitutes slightly more than half of all taxable returns. As a result of this change alone, some 8.7 million taxpayers presently itemizing their deductions, or 27 percent of the total, can be expected to shift to the standard deduction, raising the proportion of taxpayers using this deduction from 58 percent to nearly 70 percent. This is without regard to the impact of the low-income allowance described below.

Taking into account the impact of both the standard deduction and the low income allowance, 11.6 million taxpayers are expected to shift over from itemized returns to standard deduction returns. This will increase the proportion using the standard deduction to 73.5 percent of all returns.

Revenue effect.—The tax reduction from the three-step increase in the standard deduction (over and above the tax reductions arising from the low income allowance and related phaseouts) is estimated at $1,087 million in 1970, $1,325 million in 1971, and $1,373 million in 1972 and thereafter.

2. Low Income Allowance (sec. 801 of the bill and sec. 141 of the code)

Present law.—The minimum standard deduction is $200 plus $100 for each personal exemption up to a total of $1,000.

General reason for change.—Inflationary price increases have had their most severe impact in the erosion of the already inadequate purchasing power of the poor. In addition, recent studies of the economic conditions of the poor by the Department of Health, Education, and Welfare have indicated that, even with the present minimum standard deduction, many persons with incomes below the poverty level are subject to tax and in addition, substantial tax burdens are imposed on those with incomes immediately above the poverty levels. At the present time there still are some 5.2 million taxable returns at or below the recognized poverty levels.

General explanation of provision.—Over a period of 3 years (2 years in the House bill), the committee amendments revise the minimum standard deduction of $200 plus $100 for each exemption (with a total of up to $1,000) to a flat $1,100 minimum standard deduction for all returns.[1]

This increases the level at which taxation begins (minimum standard deduction plus exemptions) from $900 to $1,700 in the case of a single person, or an $800 increase. For a married couple, the increase is from $1,600 to $2,300, a $700 increase. For each additional exemption this increase in the minimum standard deduction is $100 less. The reason for substituting the flat $1,100 minimum standard deduction or low income allowance for the present minimum standard deduction which varies in size (to the extent of $100) with the number of exemptions after the first is because, of the many possible alternatives, this most nearly conforms the nontaxable levels with the proverty levels. The nontaxable levels under prsent law and under this low income allowance are compared in table 19 below with the proverty income levels for 1969 (based upon earlier HEW levels with price adjustments).

TABLE 19.—COMPARISON OF POVERTY LEVELS TO BEGINNING TAX LEVELS UNDER PRESENT LAW AND WITH THE $1,100 LOW INCOME ALLOWANCE

Family size	Nontaxable level[1]		"Poverty income levels" 1969[2]	Increase in poverty level for additional person	Estimated number of taxable poor family units (thousands)
	Present law	Low-income allowance			
	(1)	(2)	(3)	(4)	(5)
1	$900	$1,700	$1,735	....	1,150
2	1,600	2,300	2,240	$505	620
3	2,300	2,900	2,755	515	150
4	3,000	3,500	3,535	780	120
5	3,700	4,100	4,165	630	50
6	4,400	4,700	4,675	510	40
7	5,100	5,300	5,180	505	[3] 50
Total taxable family units					2,180

[1] Present low minimum standard deduction or low income allowance plus personal exemptions.
[2] Assumed to be 6 percent above HEW nonfarm "poverty levels" for 1966.
[3] Seven or more persons.

The poverty levels in this table appear in column 3. Column 4 indicates the increase in poverty levels as the number in the family increases. An examination of this column indicates an average increase of approximately $600 which corresponds with the present $600 per capita personal exemption. However, as is also indicated by this table, the poverty level for a single person is slightly over $1,700 indicating the need for a starting tax-free level over that amount. Column 5 in this table shows that of the slightly over 2 million poor family units presently subject to tax, over one-half of the total have only one person in the family, many of whom would be subject to tax if any tax-free

[1] This amount is to be $550 in the case of a husband and wife filing separate returns.

income level below $1,700 were to be adopted. The $1,100 low income allowance or minimum standard deduction under the committee amendments is not fully effective until 1972. In 1970 and 1971, transitional features are provided which have the effect of limiting the benefits of the additional allowance added by this bill to those at or immediately above the poverty level.

This transition is accomplished by phasing out the additional allowance in 1970 and 1971. In 1970 both the committee amendments and the House bill provide that the benefit of the low income allowance is to be phased out on the basis of $1 for every $2 of adjusted gross income the taxpayer has above the tax-free level. In the case of a single person, for example, this would mean that the $800 additional allowance would be phased out over an income span of $1,600 above the $1,700 of tax-free income, or would be entirely phased out at an income level of $3,300. For a married couple, the additional allowance phased out on this basis is $700. In this case the $700 is phased out over a $1,400 income span above the tax-free level of $2,300, or is phased out at $3,700.

In 1971, the House bill would have eliminated the phaseout. The committee's amendments, however, retain a modified phaseout as a part of an effort to minimize the fiscal impact of tax reductions in 1971.[2] The phaseout of the additional allowance in 1971 is on the basis of $1 for every $15 of adjusted gross income above the tax-free level.

Both versions of the bill provide that married couples filing separate returns in 1970 and 1971 generally are not to have the benefit of the additional allowance provided by the bill. However, to provide for the case of a family abandoned by one of the parents, both versions of the bill specify that a married individual, under certain conditions, may obtain the full low income allowance even though not filing a joint return. In addition, such an individual when electing the percentage standard deduction may deduct an amount up to the full ceiling rather than only up the ceiling provided for married individuals filing separately and (if he or she otherwise qualifies for head of household status) may also use the tax rates for head of household. These conditions require that the individual must not file a joint return, but must maintain a household which is the principal place af abode of one or more dependents. The dependent in question must be a son or daughter (or step-son or step-daughter) for which the individual is entitled to a dependency exemption. The individual must furnish more than half the cost of maintaining the household and during the entire taxable year the individual's spouse must not be a member of the household in question.[3]

Approximately 11.8 million returns will benefit in 1970 from the low income allowance and 5.2 million will become nontaxable. In 1972, when the phaseout is no longer applicable, 36.8 million taxpayers are expected to benefit from the $1,100 minimum standard deduction of which 5.5 million will have become nontaxable over the period. In addition, 5.7 million are expected to shift from itemized deductions to the standard deduction in response to the low income allowance.

[2] Under the committee amendments in addition to retaining the modified phaseout described above, the committee amendments provide that one-third rather than one-half of the rate reduction is to become effective in 1971.

[3] If the conditions are no longer met, as, for example, where the dependent no longer lives in the household, such individual reverts to the status of a married individual filing a separate return.

Revenue effect.—The revenue effect of the low income allowance in 1970 is estimated at $625 million. In 1971 with the higher phaseout the revenue loss is $1,687, and in 1972 and thereafter with the full phaseout, or when the low income allowance in effect becomes a $1,100 minimum standard deduction, the estimated revenue loss is $2,652 million.

3. Tax Treatment of Single Persons (sec. 802 of the bill and sec. 1 of the code)

Present law.—Since the Revenue Act of 1948, married couples have had the option of being taxed under the split-income provision. This, in effect, taxes a married couple as if it were composed of two single individuals each of whom had one-half the couple's combined income. This 50–50 split of income between the spouses for tax purposes generally produces a lower tax than any other division of income since the application of the graduated tax rates separately to each of the two equal parts comprising the couple's income keeps the total income in lower tax brackets. In effect, the split-income provision achieves this result by allowing married couples who exercise the option of filing joint returns to use a tax-rate schedule with tax brackets twice as wide as those applying to single people and spouses filing separate returns.

As a result of income splitting, married couples pay lower taxes than single people at the same income levels.

In 1951, a head-of-household provision was enacted to grant partial income-splitting to widows, widowers, and certain other single persons with dependents in their households. Individuals who qualify under this provision are allowed approximately one-half of the income-splitting benefits given to married couples. These heads of households use a different tax rate schedule which, at any given level of income, produces a tax liability about halfway between the tax paid by a married couple filing a joint return and a single individual.

Beginning in 1954 surviving spouses with dependent children were permitted to use the joint return tax rates with full income-splitting for two taxable years following the death of the husband or wife.

General reasons for change.—The committee concluded that the difference in tax liability between single persons and married couples filing joint returns is too large. Under present law, the tax rates imposed on single persons are too heavy relative to those imposed on married couples at the same income level; a single person's tax is as much as 40.9 percent higher than the tax paid on a joint return with the same amount of taxable income. While some difference between the rate of tax paid by single persons and joint returns is appropriate to reflect the additional living expenses of married taxpayers, the existing differential of as much as 41 percent which results from income-splitting cannot be justified on this basis.

The committee concluded that the proper solution to the tax differential between married and single taxpayers is a new single person rate schedule that insures that the tax of single persons will never be more than 120 percent of that of married taxpayers with the same amount of taxable income.

Explanation of provision.—The Committee amendments provide a new, lower, rate schedule for single persons (as well as a new regular rate schedule and head-of-household rate schedule) shown in Table 20. This rate schedule is designed to provide tax liability for single persons which is 17 to 20 percent above that of married couples for taxable incomes of between $14,000 and $100,000, with the maximum differential of 20 percent being reached at $20,000. (See col. 7 of Table 21 below.) Below $14,000, where income-splitting is less beneficial, the excess of the single person's rates over those of married couples gradually decreases. This is also true above $100,000, again where the benefits of income-splitting become less significant.

The committee amendments also provide a new rate schedule for heads of households which is halfway between the new rate schedule for single persons and the rate schedule used by married couples (the "regular" rate schedule with brackets twice as wide). The "regular" rate schedule is maintained for married couples filing separate returns and for estates and trusts. The rates in all schedules reflect the general rate reduction provided elsewhere in the bill.

TABLE 20.—SENATE FINANCE COMMITTEE RATE SCHEDULES (TO BE EFFECTIVE IN 1972)

Taxable income bracket	Regular rate schedule [1]	Head-of-household rate schedule [2]	Single person rate schedule [3]	Taxable income bracket	Regular rate schedule [1]	Head-of household rate schedule [2]	Single person rate schedule [3]
0 to $500	13	13	13	$26,000 to $28,000	49	38	42
$500 to $1,000	14	13	14	$28,000 to $32,000	49	40	42
$1,000 to $1,500	15	15	15	$32,000 to $36,000	50	43	47
$1,500 to $2,000	16	15	16	$36,000 to $38,000	50	45	47
$2,000 to $4,000	18	17	18	$38,000 to $40,000	52	47	52
$4,000 to $6,000	21	19	20	$40,000 to $44,000	52	48	52
$6,000 to $8,000	23	20	22	$44,000 to $50,000	54	50	54
$8,000 to $10,000	27	22	24	$50,000 to $60,000	58	54	58
$10,000 to $12,000	30	23	26	$60,000 to $80,000	60	55	60
$12,000 to $14,000	34	25	28	$80,000 to $100,000	61	57	61
$14,000 to $16,000	37	27	30	$100,000 to $120,000	62	60	62
$16,000 to $18,000	40	29	32	$120,000 to $150,000	63	62	63
$18,000 to $20,000	42	31	34	$150,000 to $160,000	64	62	64
$20,000 to $22,000	44	32	35	$160,000 to $200,000	64	63	64
$22,000 to $24,000	47	34	37	$200,000 to $300,000	65	64	65
$24,000 to $26,000	47	36	37	Over $300,000	65	65	65

[1] This schedule is in the House bill.
[2] Available to taxpayers who qualify for head-of-household status.
[3] Schedule for all single persons and widows and widowers.

TABLE 21.—TAX LIABILITY FOR JOINT RETURNS AND SINGLE PERSONS AT SELECTED LEVELS OF TAXABLE INCOME, AT RATES PROPOSED TO BE EFFECTIVE IN 1972

Taxable income	Tax liability under House bill					Senate Finance Committee, single persons			
				Single, 35 and over					
	Joint returns [1]	Single under 35	Percent above joint return	Tax	Percent above joint return	Tax	Percent above joint return	Percent different from House for singles over 35	Percent different from House for singles under 35
$2,000	$270	$290	7.4	$280	3.7	$190	7.4	+5.7	0
$4,000	580	650	12.1	620	6.9	650	12.1	+4.8	0
$6,000	940	1,070	13.8	1,000	6.4	1,050	11.7	+5.0	−1.9
$8,000	1,300	1,530	17.7	1,420	9.2	1,490	14.6	+4.9	−2.6
$10,000	1,720	2,070	20.3	1,900	10.5	1,970	14.5	+3.7	−4.8
$14,000	2,600	3,350	28.8	2,980	14.6	3,050	17.3	+2.3	−9.0
$18,000	3,600	4,890	35.8	4,240	17.8	4,290	19.2	+1.2	−12.3
$20,000	4,140	5,730	38.4	4,940	19.3	4,970	20.0	+.6	−13.3
$26,000	6,026	8,490	41.0	7,260	20.6	7,150	18.8	−1.5	−15.8
$32,000	8,180	11,430	39.7	9,800	19.8	9,670	18.2	−1.3	−15.4
$38,000	10,620	14,430	35.9	12,520	17.9	12,490	17.6	−.2	−13.4
$44,000	13,220	17,550	32.8	15,380	16.3	15,610	18.1	+1.5	−11.0
$50,000	16,040	20,790	29.6	18,440	15.0	18,850	17.5	+2.2	−9.3
$100,000	41,580	50,790	22.2	46,140	11.0	48,850	17.5	+5.9	−3.8
$150,000	71,180	82,090	15.3	76,740	7.8	80,150	12.6	+4.4	−2.4
$200,000	101,580	114,090	12.3	108,140	6.5	111,650	9.9	+3.2	−2.1

[1] Under Senate Finance Committee bill, as well.

The committee agrees with the House that the tax differential between single and married taxpayers is excessive but does not believe that the differential should be reduced only for single persons age 35 and over (and widows and widowers) as provided in the House bill. This age 35 test seems arbitrary and unrelated to the basic issue of whether there is too great a tax difference between single and married taxpayers resulting from marital status. In addition, there is good reason for maintaining a tax differential between single persons and heads-of-households who in fact maintain a household for a dependent. This distinction would, of course, be eliminated under the House bill. In view of these considerations, the committee substituted for the House provision the rate schedule which limits the tax paid by all single persons regardless of age to no more than 120 percent of the tax paid by married taxpayers at the same taxable income level.

Revenue effect.—The revenue loss from this provision is $445 million annually. The revenue cost of the rate schedule for single persons in the House bill would be $650 million.

Effective date.—The new rate schedule for single persons is effective in two stages, in 1971 and 1972, with over one-third of the reduction from present rates to take place in 1971 and the remainder in 1972 (as is also the case with the general rate reduction).

4. Individual Income Tax Rates (sec. 802 of the bill and sec. 1 of the code)

Present law.—The individual income tax rates under present law range from 14 percent on the first $500 of taxable income for a single taxpayer and $1,000 for a joint return to 70 percent on taxable income in excess of $100,000 for a single taxpayer and $200,000 for a joint return as shown by the rate schedule below (table 22).

General reasons for change.—The committee concluded that reducing tax rates is the most effective way to provide a uniform distribution of the tax relief which can be provided above the relief provided through the higher standard deduction and low income allowance (or minimum standard deduction). In this way taxpayers at all income levels, including those in the lower income brackets where the benefits from the low income allowance and higher standard deduction are concentrated, receive tax relief.

In addition, the committee believes that tax rates ranging up to 70 percent are unrealistically high. They take too large a portion of the income of those subject to the full impact of rates. Such high rates also encourage many taxpayers to shelter their income from the top rates by using tax avoidance techniques which have frequently developed into tax loopholes.

Explanation of provisions.—The House bill and committee amendments provide the same rate reductions for 1972. The tax rates are reduced by at least one percentage point in all brackets, the reduction varying in the different brackets so as to produce a reduction in tax of 5 percent or more in all brackets. Thus, for example, the top rate is reduced from 70 to 65 percent. Both the House bill and the committee amendments provide that the rate reduction is to take place in two stages in 1971 and 1972 because the revenue loss of nearly $4.5 billion from the full reduction would be excessive if fully effective in 1971.

The committee amendments, in order to reduce the fiscal impact of the large revenue loss in 1971, provide a lesser rate reduction in that year than does the House bill. The House bill provides the rate reduction evenly between 1971 and 1972. The committee amendments provide for approximately one-third (37.5 percent) of the rate reduction to occur in 1971 and the remaining two-thirds in 1972. Under the rate reductions provided by the House bill for 1971, the revenue loss would have been $2,249 million in that year. With the committee's modification, the revenue losss is reduced to $1,687 million, a difference of $562 million.

The rates shown below reflect the general reduction from present law but are directly applicable only to married couples filing separate or joint returns. The new rate schedule provided single taxpayers and heads-of-households is discussed in the preceding section of this report dealing with the tax treatment of single persons. The rates applicable to married couples filing separate returns also apply to estates and trusts taxed as individuals.

The new tax rates are to be incorporated (along with the low-income allowance and higher standard deduction) into the optional tax table prescribed by the Secretary of the Treasury. Separate optional tax tables will be provided for single persons, married taxpayers filing joint returns, heads-of-households, married taxpayers filing separate returns who use the percentage standard deduction, and married taxpayers filing separate returns who use the low-income allowance.

The income level below which the optional table may be used is increased from the present $5,000 to $7,500. In addition, the Secretary of the Treasury may prescribe an optional tax table for income levels up to $10,000 if it is feasible. This Internal Revenue Service is attempting to develop a simple format.

The committee's bill also eliminates the provision (sec. 1(c)) which limits tax liability to 87 percent of taxable income since it is no longer applicable with tax rates below that level. The division of tax into a 3 percent normal tax and a surtax is also eliminated because it is no longer necessary.

Effective date.—The first stage of the rate reduction is to be applicable for taxable years beginning after December 31, 1970, and full reduction is to be applicable to taxable years beginning after December 31, 1971.

For taxpayers with fiscal years falling partially in either the calendar year 1971 or 1972, there will be a proration of the rates applicable in the two years involved, according to the number of days in the fiscal year in question which falls in each calendar year. The change in the capital gains rate for individuals will be treated in the same manner but in this case the calendar years involved are 1970, 1971, and 1972. In addition, for fiscal year taxpayers the changes in the low-income allowance and the percentage standard deduction which occur in 1970, 1971, and 1972 are to be prorated in computing taxable income in the same manner as the rate changes.

Revenue effect.—The revenue loss from the first stage of the rate reduction in 1971 is $1,687 million and the revenue loss from the full reduction in 1972 is $4,498 million.

TABLE 22.—INDIVIDUAL INCOME TAX RATE SCHEDULE FOR MARRIED TAXPAYERS UNDER PRESENT LAW, UNDER HOUSE AND SENATE FINANCE COMMITTEE BILLS FOR CALENDAR YEARS 1971 AND 1972

Taxable income bracket		Tax rate (percent)			
			1971		1972
Married (separate)	Married (joint)	Present law	House bill	Senate Finance Committee bill	House and Senate Finance Committee bill
$0 to $500	$0 to $1,000	14	13.5	13.6	13
$500 to $1,000	$1,000 to $2,000	15	14.5	14.6	14
$1,000 to $1,500	$2,000 to $3,000	16	15.5	15.6	15
$1,500 to $2,000	$3,000 to $4,000	17	16.5	16.6	16
$2,000 to $4,000	$4,000 to $8,000	19	18.5	18.6	18
$4,000 to $6,000	$8,000 to $12,000	22	21.5	21.7	21
$6,000 to $8,000	$12,000 to $16,000	25	24	24.4	23
$8,000 to $10,000	$16,000 to $20,000	28	27.5	27.6	27
$10,000 to $12,000	$20,000 to $24,000	32	31	31.3	30
$12,000 to $14,000	$24,000 to $28,000	36	35	35.3	34
$14,000 to $16,000	$28,000 to $32,000	39	38	38.3	37
$16,000 to $18,000	$32,000 to $36,000	42	41	41.3	40
$18,000 to $20,000	$36,000 to $40,000	45	43.5	43.9	42
$20,000 to $22,000	$40,000 to $44,000	48	46	46.5	44
$22,000 to $26,000	$44,000 to $52,000	50	48.5	48.9	47
$26,000 to $32,000	$52,000 to $64,000	53	51	51.5	49
$32,000 to $38,000	$64,000 to $76,000	55	52.5	53.1	50
$38,000 to $44,000	$76,000 to $88,000	58	55	55.8	52
$44,000 to $50,000	$88,000 to $100,000	60	57	57.8	54
$50,000 to $60,000	$100,000 to $120,000	62	60	60.5	58
$60,000 to $70,000	$120,000 to $140,000	64	62	62.5	60
$70,000 to $80,000	$140,000 to $160,000	66	63	63.8	60
$80,000 to $90,000	$160,000 to $180,000	68	64.5	65.4	61
$90,000 to $100,000	$180,000 to $200,000	69	65	66.0	61
$100,000 to $120,000	$200,000 to $240,000	70	66	67.0	62
$120,000 to $150,000	$240,000 to $300,000	70	66.5	67.4	63
$150,000 to $200,000	$300,000 to $400,000	70	67	67.8	64
$200,000 and over	$400,000 and over	70	67.5	68.1	65

Note: Under present law the taxable income brackets and rates shown for married taxpayers filing separate returns are also applicable to single persons.

5. Collection of Income Tax at Source on Wages (sec. 803 of the bill and sec. 3402 of the code)

Present law.—Present law provides withholding tables and a percentage withholding method which incorporate the $600 personal exemption, the minimum standard deduction, the 10 percent standard deduction and the tax rates.

General reasons for change.—To maintain the correspondence between tax liability and tax withheld, it is necessary to incorporate changes in the minimum standard deduction, the 10 percent standard deduction, and the tax rates into the withholding rates and tables.

Explanation of provision.—The House bill requires the Internal Revenue Service to prescribe new withholding rates and tables. On the other hand, the committee amendments include new withholding rates in the bill but require the Internal Revenue Service to prescribe withholding tables based on these rates. The rates (and tables) incorporate the following: for 1970, the low-income allowance (with the phaseout) and the 13 percent standard deduction (with the $1,400 ceiling); for 1971, the low-income allowance (with the phaseout), the 14 percent standard deduction (with the $1,700 ceiling), and the new tax rates; and for 1972, the low-income allowance (without the phaseout), the 15 percent standard deduction (with the $2,000 ceiling), and the fully reduced tax rates. For the first six months of 1970, the bill also provides withholding rates which reflect the 5 percent surcharge.

In the case of a husband and wife who are both subject to withholding, the withholding system will, in effect, provide each of them with the low-income allowance even though when filing their return they are entitled to only one low-income allowance. This "doubling up" of the low-income allowance tends to create underwithholding. Since the withholding system cannot practically be designed to distinguish between single-earner and two-earner families, the Internal Revenue Service will warn taxpayers of this underwithholding possibility and inform employees how to adjust to avoid it. The adjustment could be, for example, that neither spouse would claim a $600 personal exemption. This would approximately offset the extra $1,100 low-income allowance by a $1,200 reduction in personal exemptions claimed for withholding purposes.

Effective date.—The above changes in the withholding rates and tables are to be effective for 1970, 1971, and 1972, respectively. For 1970, the withholding changes are to be effective for wages paid after December 31, 1969, or the 15th day after enactment of the bill, whichever is later.

6. Provision for Flexibility in Withholding Procedures (sec. 803 of the bill and sec. 3402(h) of the code)

Present law.—Under present law, employers are limited to methods of computing wage withholding which are specified in the code (the withholding tables or percentage method) or are limited to essentially equivalent methods. Employers are permitted by the code (sec. 3402(h)) to withhold on the basis of average wages to be paid during a calendar quarter, but present law requires that the total amount withheld during the quarter must be the amount that would result from the regular withholding methods, rather than the amount that would result if wages were averaged over a longer period.

General reasons for change.—Employers in some cases have devised withholding methods, frequently in conjunction with computerized payroll operations, which produce approximately the same amount of withholding as the regular methods but are substantially easier for employers to administer. Under present law, the Internal Revenue Service has no authority to permit employers to use such methods. The committee concluded that it is desirable to provide employers with this flexibility. There also are a number of types of employment situations where the existing permissible withholding methods do not accurately match tax liability and tax withheld. This is the case, for example, where wage payments vary significantly in size from one pay period to another and the existing withholding rules create overwithholding. Another pattern of wage payments that creates overwithholding is where an employee does not receive wages throughout the entire year as in the case, for example, of teachers and professional athletes.

The committee concluded that it is desirable to make provision for additional withholding methods which result in a closer correspondence between tax withheld and tax liability where wage payments are not received regularly throughout the year.

Explanation of provisions.—The committee amendments provide employers greater flexibility in their withholding procedures by authorizing the Secretary of the Treasury to permit them to use any method which results in substantially the same amount of withholding as the regular methods.

The committee amendments also permit employers to "annualize" wage payments for withholding purposes. This will make the computation of withholding easier for many large employers whose payroll computations are handled by a computer. This provision is an extension of sec. 3402(h) which permits withholding on average wages for a calendar quarter but, in contrast to that section, does not require that the amount of withholding for the year (quarter) be the same as required by the regular methods.

Under the annualizing method, an employer could: (1) multiply the amount of wages for one payroll period by the number of periods of similar length in the year to obtain the approximate total annual wages; (2) determine the annual amount of withholding required on the total wages from (1); (3) divide the annual withholding amount by the number of payroll periods and withhold the resulting amount for the payroll period.

To deal with cases where wage payments are quite irregular, the committee amendments provide withholding on the basis of cumulative wages and cumulative withholding.

Another type of earning pattern that may result in overwithholding under present law is employment for only part of the year as in the case, for example, of teachers and professional athletes. The committee amendments authorize the Secretary of the Treasury to issue regulations which permit withholding methods that withhold the correct amount of tax for the entire year. This flexibility is intended to permit the Secretary of the Treasury to authorize use of withholding methods to deal with cases such as part-year employment if the Internal Revenue Service is able to develop methods that are administratively satisfactory.

No comparable provision was in the House bill.

Effective date.—These provisions are to apply to wages paid after December 31, 1969, or 15 days after the date of enactment of the bill, whichever is later.

7. Additional Withholding Allowances for Excess Itemized Deductions (sec. 803(e) of the bill and sec. 3402(m) of the code)

Present law.—Under present law, taxpayers who have estimated itemized deductions which exceed the level of deductions on which the withholding tables are based many claim an additional exemption for withholding purposes for each $700 of itemized deductions above a threshold level (10 percent of the first $7,500 of estimated wages and 17 percent of any remainder). The estimated itemized deductions in this case may be no larger than actual itemized deductions for the prior year.

General reasons for change.—The requirement that estimated itemized deductions be no larger than actual deductions for the preceding year effectively prevents the provision from operating the first year in which the taxpayer has excess itemized deductions even though their existence is clear and need not be verified by similar experience in a prior year. The committee concluded that the prior year requirement could be modified in certain cases.

The committee also believes it appropriate to permit an additional withholding allowance where itemized deductions exceed the threshold level by less than $700 but where they still cause overwithholding.

In addition, because of the increase in the standard deduction percentage from 10 to 15 percent, the 10-percent threshold needs to be increased.

Explanation of provisions.—The committee amendments eliminate the prior year requirement for excess itemized deductions in cases where the excess itemized deductions are substantiated by a court order (such as one providing for the payment of alimony) or by other evidence which verifies their existence. Thus, estimated itemized deductions for the year may equal the total of the itemized deductions (or standard deduction) claimed in the prior year plus itemized deductions in excess of that amount which are demonstrably attributable to an identifiable event during the estimation year or the prior year. The committee amendments also provide that an additional withholding allowance is to be permitted for excess itemized deductions of between $300 and $600. (The value of a withholding exemption is $600 rather than $700 once the minimum standard deduction of $100 per exemption is eliminated).

The amendments also raise the percentage threshold for determining excess itemized deductions to conform to the higher standard deduction provided by the bill. The 10 percent applicable to the first $7,500 is increased to 15 percent and, since that is close to the 17 percent, the committee concluded that the 17 percent requirement and the $7,500 test could be eliminated to simplify the provision. Thus, excess itemized deductions are to be those in excess of 15 percent of estimated wages. No comparable provision was in the House bill.

Effective date.—This provision is to be effective for wages paid after December 31, 1969, or 15 days after the enactment of the bill, whichever is later.

8. Certification of Nontaxability for Withholding Tax Purposes (sec. 803(f) of the bill and sec. 3402 of the code)

Present law.—Present law does not excuse employees from withholding on their wages or salaries if their incomes during the period of their employment are above specified levels even though they know, for other reasons, that they will have no tax liability for the year.

General reasons for change.—Because wage withholding tables are based on the assumption that an employee will work throughout the entire year, in order to receive the full value of his personal exemptions and the new low-income allowance for withholding purposes he must, in fact, work for most of the year. Many taxpayers who work only a part of the year have tax withheld from their wages even though they have no tax liability for that year. Consequently, these employees must file a tax return and claim a refund for this excess withholding.

This represents a problem, especially for students who work part-time during the summer but whose incomes fall below the new levels at which tax begins. This is substantially higher than under present law because of the low-income allowance contained in the committee's bill. In addition, the withholding rates and tables are based on the assumption that the taxpayer does not have large itemized deductions (except for the special provision discussed in number 7 above). As a result, some taxpayers with large itemized deductions also find themselves in a nontaxable status even though there may have been

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significant withholding in their cases. The committee concluded that, in conjunction with the increase in the income level at which filing a return is required, it would be appropriate to relieve individuals from filing a tax return solely to obtain a refund of their excess withholding.

Explanation of provision.—The committee amendments provide that an individual is not to be subjected to withholding of Federal income tax if he certifies to his employer that he expects to have no Federal income tax liability for the current year, and, in fact, had no income tax liability in the prior year.

In conjunction with the higher filing requirement, this certification provision could potentially relieve as many as 10 million persons from overwithholding although it is unlikely that all those potentially eligible would take advantage of this procedure.

The reduction in the number of returns filed and refunds processed as a result of this provision represents not only a saving of time and effort for taxpayers but also a substantial administrative saving to the Internal Revenue Service.

No comparable provision was in the House bill.

Effective date.—This provision is to be applicable for wages paid after April 30, 1970.

9. Withholding on Supplemental Unemployment Benefits (sec. 803(g) of the bill and sec. 3402 of the code)

Present law.—Under present law, supplemental unemployment benefits are not subject to withholding because they do not constitute wages or remuneration for services.

General reasons for change.—Supplemental unemployment compensation benefits (SUB) paid by employers are generally taxable income to the recipient. Consequently, the absence of withholding on these benefits may require a significant final tax payment by the taxpayer receiving them. The committee concluded that although these benefits are not wages, since they are generally taxable payments they should be subject to withholding to avoid the final tax payment problem for employees.

Explanation of provision.—The committee amendments require the payor of taxable supplemental compensation unemployment benefits to withhold Federal income tax from these payments. The withholding requirements applicable to withholding on wages are to apply to these nonwage payments.

For purposes of withholding, supplemental unemployment compensation benefits are defined to include benefits which are paid to an employee pursuant to a plan to which the employer is a party because of the employee's involuntary separation from employment (whether or not such separation is temporary), resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions but only to the extent such benefits are subject to tax.

No comparable provision was in the House bill.

Effective date.—This provision is to apply to such payments made after December 31, 1970.

10. Voluntary Withholding on Payments Not Defined as Wages (sec. 803(g) of the bill and sec. 3402 of the code)

Present law.—Present law specifically excludes certain types of remuneration from the definition of wages and makes no provision for withholding in such cases. Voluntary withholding is unavailable under present law in such cases even though the payments are received from a person constituting an employer and both the employer and employee agree to the additional withholding. Moreover, withholding is not authorized in the case of annuities and other nonwage type payments even though withholding would be desirable in many cases.

General reasons for change.—The inability of a person to have tax withheld on the remuneration he receives means that he may have a substantial and possibly burdensome final tax payment. This often occurs, for example, in the case of persons receiving retirement income or income from annuities and also in the case of earnings of farm and domestic workers.

Explanation of provision.—The committee amendments provide for employer withholding on payments for pensions and annuities when an employee or recipient requests such withholding. If an employee or other recipient requests withholding on these payments, the employer or payor would be required to comply with the request. Withholding would apply only in the case of pensions or annuities received over more than one year; it would not apply to lump-sum payments. In addition, withholding would apply only to the taxable portion of such pension or annuity payments. Thus, recipients of Civil Service retirement benefits, and those receiving certain veterans benefits and payments under insurance contracts could request the payor to withhold income tax from these payments.

The committee amendments also authorize the Secretary of the Treasury to issue regulations which provide rules for withholding on any remuneration for services which is not included in the definition of wages, and for any other type of payment for which the Secretary finds withholding appropriate in cases where both the employer and employee (or payor and payee) agree to such withholding. The rules could cover such situations as wages paid to farm and domestic workers or payments of interest and dividends. In these cases, as well as in the case of pensions and annuities, the amounts withheld will be those required by the regular rates or tables and the rules applicable to withholding from wages will apply.

No comparable provision was in the House bill.

Effective date.—Withholding on pensions and annuities is to apply to such payments made after December 31, 1970 to provide employers or other payors time to prepare their withholding procedures. Withholding where both payor and payee agree to such withholding is to apply to payments made after June 30, 1970.

Z. MISCELLANEOUS INCOME TAX PROVISIONS

1. Qualified Pension, etc., Plans of Professional Corporations (sec. 901 of the bill and sec. 72(p) of the code)

Present law.—Under present law, the amounts which self-employed individuals may set aside annually on a tax-free basis for pensions in a qualified plan is limited to 10 percent of the individual's compensation, or $2,500, whichever is less. These are the limitations imposed with respect to plans established under the Self-Employed Individuals Retirement Act of 1962 (the so-called H.R. 10 type pension plans). In the case of employees of a corporation, however, there are no limitations as to the amounts which may be set aside on a tax-free basis for the employees to fund their pensions under qualified plans which do not discriminate as to benefits and coverage in favor of highly compensated employees, supervisory employees, shareholders, or officers of the corporation.

Generally, doctors, lawyers, accountants, and certain other professional persons have been unable in the past to carry on their professions through the form of corporations because of the personal nature of their responsibility or liability for the services performed for a patient, client, etc. In recent years, however, most States have adopted special incorporation laws which provide for what are generally known as "professional corporations" (or associations).[1] These professional corporations or associations have been used increasingly by groups of professional persons. The more favorable tax treatment provided for pensions in the case of corporate employees as compared to pension plans for self-employed persons in partnerships or proprietorships generally has been considered to be the primary motivation for the formation of such professional corporations.

The Internal Revenue Service, in the so-called *Kinter* regulations,[2] held that professional service organizations (i.e., corporations or associations) were not taxable as corporations (and thereby not eligible for the more favorable corporate pension plan rules) largely because the personalized responsibility or liability existing in the case of the professional persons acting as shareholder-employees with respect to their patients, clients, etc., was considered to be inherently different from the business relationships characteristic of an ordinary business corporation.

Recent court cases, however, have overturned the 1965 regulations, holding that organizations of professional persons in professional corporations or associations are to be treated as corporations for Federal income tax purposes.[3] The Internal Revenue Service has recently acquiesced in these cases and has informed taxpayers that "organizations of doctors, lawyers and other professional people organized under State professional association acts will, generally, be treated as corporations for tax purposes."[4]

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[1] Only New York, Wyoming, and the District of Columbia have not adopted such incorporation laws.

[2] Treas. Reg. § 301.7701-2(h). (T.D. 6503, Nov. 15, 1960 and amended by T.D. 6797, Jan. 2, 1965.); Rev. Rul. 56-23, 1956-1 C.B. 598, which rejected the decision in *United States* v. *Kintner*, 216 F. 2d 418 (9th Cir. 1954), aff'g. 107 F. Supp. 976.

[3] See *O'Neill* v. *United States*, 40 F. 2d 888 (6th Cir. 1969), aff'g. 281 F. Supp. 359 (N.D. Ohio 1968); *Kurzner* v. *United States*, 413 F. 2d 97 (5th Cir., 1969), aff'g. 286 F. Supp. 839 (S.D. Fla. 1968); *Holder* v. *United States*, 289 F. Supp. 160 (N.D. Georgia 1968) aff'd 412 F. 2d 1189 (5th Cir., 1969); *Wallace* v. *United States*, 294 F. Supp. 1225 (E.D. Ark. 1968); *Empey* v. *United States*, 272 F. Supp. 851 (D.C. Colo. 1967), aff'd 406 F. 2d 157 (10th Cir., 1969).

[4] Internal Revenue Service, Technical Information Release (TIR-1019), Aug. 8, 1969.

General reasons for change.—Congress, in enacting the Self-Employed Individuals Retirement Act of 1962 (H.R. 10 pension plans), made it clear that it intended to impose limitations as to the amounts which may be set aside annually on a tax-free basis for eventual pension payments to self-employed persons. The formation of professional corporations, while maintaining the personal or confidential relationship between the professional shareholder-employee and the patient or client, has had the effect of circumventing the limitations Congress intended to impose with respect to contributions to qualified pension, etc., plans by individuals doing business as proprietors or partners.

The committee recognizes that there are disparities in the tax treatment of self-employed individuals and corporate employees with respect to pension plans, and that this problem needs attention. The committee understands that these disparities are being studied, and that the Treasury Department and committee staffs are expected to report back with recommendations to deal with these problems. In the interim, however, it appears inappropriate to the committee to permit certain professional individuals who in most respects are still essentially self-employed persons to avoid the pension limitations prescribed by Congress.

Explanation of provision.—The committee amendments provide that shareholder-employees of a professional service organization are to include in their gross income the amount of contributions paid on their behalf which are deductible under qualified pension, profit-sharing, and stock bonus plans (under sec. 404(a) (1), (2), or (3)), to the extent that these contributions exceed 10 percent of the compensation received by the shareholder-employee from the organization, or $2,500, whichever is less. Also to be taken into account for this purpose are forfeitures allocated to the shareholder-employee's account under stock bonus or profit-sharing plans. Where an individual is covered by plans of more than one organization, the Treasury Department, by regulations, is to aggregate the contributions paid on his behalf in making the computations referred to above. If a professional service organization is also an electing subchapter S corporation, the limitations on qualified pension, etc., plans that are applicable to a subchapter S corporation will also apply.[5]

The amounts included in the shareholder-employee's gross income under this provision are to be treated as a part of his consideration or cost for the pension, etc., plan when the plan benefits are eventually received by him. If the rights of the shareholder-employee (or his beneficiary), under a plan to which this provision applies, terminate before he receives sufficient payments to cover the amounts which he previously included in gross income, he (or his beneficiary) is to be permitted to deduct these amounts (equal to the amount previously included in gross income which has not been returned to him on a tax-free basis) in the year in which his rights under the plan terminate.

The term "professional service organization" under this provision means any corporation in which the beneficial ownership, or control is limited under State or local law or rules of professional ethics to indi-

[5] Thus, forfeitures could not be allocated to accounts of employees who own more than 5 percent of the stock of the subchapter S corporation. Moreover, the limit on contributions would continue to apply notwithstanding the election under subchapter S, even where the professional person has less than a 5 percent interest in the subchapter S corporation.

viduals who are required to be licensed or otherwise authorized under State or local law to perform professional services necessary to carry on the trade or business in which the corporation is engaged. This provision also covers the executor or administrator of an individual described above. A "shareholder-employee" is an employee of a professional service organization who owns a beneficial interest in such an organization.

There is no comparable provision in the House bill.

Effective date.—This provision applies to taxable years beginning after December 31, 1969.

Revenue Effect.—Current data are not available on which to base an estimate of the revenue saving under this provision. The immediate impact, however, is not believed to be large. In the longer run, however, it is believed that the revenue saving under this provision will be quite substantial.

2. Amounts Received Under Insurance Contracts for Certain Living Expenses (sec. 902 of the bill and sec. 123 of the code)

Present law.—Under existing law, as interpreted by the Internal Revenue Service and by the courts, a person who has his residence damaged or destroyed by fire or other casualty and who must temporarily find another residence while his home is being repaired must treat any insurance payments covering the additional living expenses caused by this situation as taxable income.[1]

General reasons for change.—The committee believes that it is inappropriate to treat insurance payments of the type described above as "income." In fact, they merely reimburse the taxpayer for a real casualty loss; namely, the expenses incurred above the normal living expenses because, for a period of time, he does not have the use of the property. The effect of present law as interpreted by the Internal Revenue Service and the courts is to cause the insured to have a net loss on a reimbursement (under an additional living expense provision of a homeowner's or renter's insurance policy) equal to the income tax he has to pay on the proceeds of the policy. Moreover, the situations giving rise to these insurance payments are beyond the control of the taxpayer.

Explanation of provision.—The committee amendments, in the case of an individual whose principal residence is damaged or destroyed by fire, storm or other casualty,[2] provide that gross income does not include amounts received under an insurance contract as reimbursement for living expenses incurred for himself and members of his household resulting from the loss of use or occupancy of the residence. However, this exclusion is limited to the excess of actual living expenses incurred by the taxpayer and members of his household over the normal living expenses which they would have incurred during this period.

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[1] In 1959, in Rev. Rul. 59-360 (1959-2 C.B. 75), the Internal Revenue Service ruled that insurance payments for additional living costs were not reimbursements for the loss of property but rather constituted income within the meaning of section 61 of the Code. Also, the Tax Court (in *I. H[illegible] Mill[illegible] Jr.*, 46 T.C. 751, 7[illegible] (1[illegible]) aff'd. 387 F. 2d 420 (8th Cir., 1968)) held that additional living expenses are not deductible as a casualty loss under section 165 and that reimbursements for these expenses must be included in the taxpayer's income.

[2] This provision also covers the person who is denied access to his principal residence by governmental authorities because of the occurrence or threat of occurence of such a casualty.

The additional living expense insurance coverage is intended to reimburse the insured for certain excess living expenses incurred during a period in which his residence may not be used. Generally, these expenses include the additional costs actually incurred for renting suitable housing and extraordinary expenses for transportation, food, utilities, and miscellaneous services. However, the exclusion is intended to be limited to reasonable expenses in excess of normal living expenses which, for purposes of this provision include only those required to maintain the insured and his household in the same standard of living that they enjoyed before the loss occurred.

There is no comparable provision in the House bill.

Effective date.—This provision is to apply to amounts received on or after January 1, 1969.

Revenue effect.—It is estimated that the revenue loss from this provision will be negligible.

3. Deductibility of Treble Damage Payments, Fines, Penalties, etc. (sec. 903 of the bill and sec. 162 of the code)

Present law.—At the present time there is no statutory provision setting forth a general "public policy" basis for denying deductions which are "ordinary and necessary" business deductions. Nevertheless, a number of business expenses have been disallowed on the ground that the allowance of these deductions would be contrary to Federal or State "public policy." This has been true, for example, in the case of fines. One question which arises in this regard is whether deductions should be allowed for damages paid to a private party in a cause of action in which the successful party is entitled to damages in a greater amount than the economic loss demonstrated by him. Under section 4 of the Clayton Act, for example, a person injured by an antitrust violation may sue for damages and recover three times the amount of economic loss established. The Internal Revenue Service (Rev. Rul. 64–224 (1964)) held that amounts paid or incurred in satisfaction of treble damage claims under that act are fully deductible as ordinary and necessary businesses expenses.

General reasons for change.—The question as to whether antitrust treble damage payments should be deductible must be viewed both from the standpoint of antitrust policy and from the standpoint of tax policy. From the standpoint of antitrust policy, the basic issues are the extent of the penalties intended and whether their impact should be reduced by permitting them to reduce taxes which otherwise would have to be paid.

From the standpoint of tax policy, there generally has been a reluctance to deny business expenses on the ground that this departs from the concept of a tax imposed on actual net business income. There still remains, however, the question as to what is an ordinary and necessary business expense. The Supreme Court in the *Tank Truck Rental* case, for example, in holding that the payment of fines could not be considered as ordinary and necessary, stated:

> A finding of "necessity" cannot be made however, if allowance of the deduction would frustrate sharply defined national or State policies proscribing the particular types of conduct evidenced by some governmental declaration thereof.

On the same grounds, it appears appropriate to deny deductions for bribes, illegal kickbacks, and the penalty portion of antitrust treble damage payments. A 1958 amendment to the Internal Revenue Code already suggests such a congressional policy. Under that amendment no deduction may be taken for payments to officials or employees of a foreign government if in the United States such payments would be unlawful. In addition, deduction of expenditures made to influence legislation are already limited by a specific provision (sec. 162(e)) added by the Revenue Act of 1962.

Explanation of provision.—The provision added by the committee amendments denies deductions for four types of expenditures: fines or similar penalties paid to a government for the violation of any law, a portion of treble damage payments under the antitrust laws following a related criminal conviction (or plea of equity or nolo contendere), deductions for bribes paid to public officials (whether or not foreign officials), and other unlawful bribes or "kickbacks." The provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is intended to be all inclusive. Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions. However, this is not, of course, intended to affect the treatment of lobbying expenditures which are already covered by the tax law.

First, the committee amendments provide that no deduction is to be allowed for any fine or similar penalty paid to a government for the violation of any law. This provision is to apply in any case in which the taxpayer is required to pay a fine because he is convicted of a crime (felony or misdemeanor) in a full criminal proceeding in an appropriate court. This represents a codification of the general court position in this respect.

Second, it is provided that if a taxpayer is convicted in a criminal proceeding for the violation of the Federal antitrust laws (or pleads guilty or nolo contendere), then no deduction is to be allowed for two-thirds of any amount paid on any judgment for damages against the taxpayer or for settlement of any action brought under section 4 of the Clayton Antitrust Act.

The deduction is denied in these cases (as well as in the case of bribes and kickbacks described below) only where there has been a criminal conviction (or a plea of guilty or nolo contendere) in a related case. This means that the deduction is to be denied only in the case of "hard-core violations" where intent has been clearly proved in a criminal proceeding. The denial of the deduction is limited to two-thirds of the amount paid or incurred since this represents the "penal" portion of the payment. The remaining one-third is to continue to be deductible on the grounds that it represents a restoration of the amount already owing to the other party.

The third category for which deductions are to be denied is illegal payments to government officials and employees. Present law (sec. 162(c)) disallows deductions for bribes to foreign officials if the making of the payment would be unlawful under United States laws if those laws would be applicable. While it has generally been presumed that deductions were not available for illegal payments to U.S. officials, this is not specified in present laws. In the case of illegal payments to government officials it is believed that the offense is sufficiently contrary to public policy as not to require the denial of the deduction to be preceded by the criminal conviction. The provision also applies, as does present law, to officials or employees of a foreign government. In this case, as under present law, the test is whether the payment would be unlawful under U.S. laws, were U.S. laws applicable to the payment. The burden of proof in this case as to whether a payment constitutes an illegal bribe or kickback is upon the Treasury Department to the same extent as if the issue related to fraud—that is, to prove the illegality by clear and convincing evidence.

The fourth category for which deductions are not to be available are illegal bribes or kickbacks to other than government officials and employees. In this case (as in the case of treble damage payments under the antitrust laws) the deduction is not to be denied unless in a criminal proceeding a taxpayer is convicted of an illegal bribe or kickback (or enters a plea of guilty or nolo contendere). The deduction in this case also is denied for any payments which are related to the illegal bribe or kickback prior to the date of the final judgment or the entering of the plea. The statute of limitations in this case is extended so that, in any case, where indictment was returned (or information filed) prior to the expiration of the statutory period for assessment, the period of the assessment of the deficiency with respect to the disallowance of a deduction is not to expire until one year after the final decision in the criminal action.

There is no comparable provision in the House bill.

Effective date.—The new provisions added with respect to fines and similar penalties and those relating to bribes and kickbacks to government officials are applicable to all taxable years to which the 1954 code applies. The denial of the deduction in the case of certain violations of the antitrust laws applies with regard to amounts paid or incurred after December 31, 1969. However, in this case the provision is not to apply with respect to any conviction or plea before January 1, 1970, or to any conviction or plea on or after that date in a new trial following an appeal of a conviction before that date. The provision relating to illegal bribes and kickbacks to other than government officials applies with respect to payments made after the date of enactment of this bill.

Revenue estimate.—It is not possible to provide a meaningful estimate of revenue obtained under this provision.

4. Deductibility of Accrued Vacation Pay (sec. 904 of the bill and sec. 97 of the Technical Amendments Act of 1958)

Present law.—Taxpayers on the accrual basis with two exceptions deduct vacation pay in the year of accrual. Thus, under present rules, vacation pay is considered to be accruable only after (1) liability to a specific person has been clearly established; (2) the amount of liability can be computed with reasonable accuracy; and (3) the accrued amount will not be forfeited by termination of employment or other cause. A taxpayer may not change his method of handling vacation pay without first obtaining the Treasury Department's approval since such a change would constitute a change of accounting method.

One of the exceptions to the requirement that taxpayers on the accrual basis must deduct vacation pay in the year of accrual relates to those who since 1949 have consistently accrued and deducted vacation pay in the year in which it was paid. They must continue this practice until they have a vested plan.

The second exception to the requirement that taxpayers must deduct vacation pay in the year in which it accrues relates to those cases where taxpayers have consistently been deducting vacation pay in the year in which the employee completes his qualifying services. To be eligible for this exception, the taxpayer must have been following this practice since 1955. This exception, however, is not available for taxable years ending after 1968.

General reasons for change.—Under the 1939 Code, the period of time for taking deductions with respect to vacation pay was when these expenses were paid or accrued or paid or incurred depending upon the method of accounting, "unless in order to clearly reflect income the deductions should be taken as of a different period." Under this latter provision, it was held that vacation pay for the next year could be accrued as of the close of the year in which qualifying services were rendered, provided all of the events necessary to fix the liability of the taxpayer for the vacation pay under the employment contract had occurred by the close of the current year. In determining whether the events necessary to fix the liability of the taxpayer for vacation pay had occurred, the fact that the employee's rights to a vacation (or payment in lieu of vacation) in the following year might be terminated if his employment ended before the scheduled period was not regarded as making the liability a contingent one instead of a fixed one. It was held that the liability was not contingent since the employer could expect the employees as a group to receive the vacation pay; only the specific amount of the liability with respect to individuals remained uncertain at the close of the year.[1]

In 1954, Congress enacted a provision, section 462, which provided for the deduction of additions to reserves for certain estimated expenses. Reserves for vacation pay, including accrual on a completion of qualifying service basis, would have been deductible under this provision and it would no longer have been necessary to maintain the administrative position described above with respect to vacation pay. As a result, in Revenue Ruling 54–608 (C.B. 1954–2, 8), the Internal Revenue Service revised its position on the deductibility of vacation pay. In this ruling, it held that no accrual of vacation pay could occur until the fact of liability with respect to specific employees was clearly established and the amount of the liability to each individual employee was capable of computation with reasonable accuracy. It was thought that taxpayers accruing vacation pay under plans which did not meet the requirements of the strict accrual rule set forth in this ruling would utilize section 462. This ruling was initially made applicable to taxable years ending on or after June 30, 1955.

Because section 462 was later repealed, the Treasury Department in a series of actions postponed the effective date of Revenue Ruling 54–608 until January 1, 1959.[2] These actions rendered Revenue Ruling 54–608 inapplicable to taxable years ending January 1, 1959.

Congress, in the Technical Amendments Act of 1958 (sec. 97), further postponed the effective date of Revenue Ruling 54–608 for two

[1] GCM 25261, C.B. 1947–2, 44; I.T. 3956, C.B. 1949–1, 78.

[2] The last of these postponements was made in Revenue Ruling 57–325, C.B. 1957–2, 302, July 8, 1957.

more years, making it inapplicable to taxable years ending before January 1, 1961. Subsequently, Congress in four actions (P.L. 86–496, P.L. 88–153, P.L. 88–554, and P.L. 89–692) further postponed the effective date of Revenue Ruling 54–608. The fourth of these laws postponed the application of the ruling until January 1, 1969.

The application of Revenue Ruling 54–608 results in the denial of a deduction in a year where the accrual of vacation pay has not been clearly fixed with respect to specific employees. However, taxpayers who have been accruing vacation pay under plans which do not meet the requirements of the strict accrual rules set forth in this ruling, if this ruling were to go into effect, would have one year in which they receive no deduction for vacation pay. This would occur since the current year's vacation pay deductions would have been accrued in the prior year and the next year's vacation pay does not meet the tests of accrual of this ruling. Congress has asked that this problem be studied and that permanent legislation be prepared. For this an additional period of time is needed.

Explanation of provision.—For reasons discussed above, the committee's bill postpones for two more years the effective date of Revenue Ruling 54–608. As a result, deductions for accrued vacation pay, if computed by an accounting method consistently followed by the taxpayer, will not be denied for any taxable year ending before January 1, 1971, solely because the liability to a specific person for vacation pay is not being clearly estimated or because the amount of the liability to each individual cannot be computed with reasonable accuracy.

No comparable provision is contained in the House bill.

Effective date.—The continuing extension of the rules which were in effect prior to 1960 is applicable for taxable years ending before January 1, 1971.

Revenue effect.—Since the amendment merely extends present rules for two additional years, there will be no revenue changes from the provision.

5. Banks for Cooperatives (sec. 905 of the bill and sec. 172 of the code)

Present law.—Under present law the thirteen existing banks for cooperatives are not allowed the same bad debt reserve deduction as commercial banks because they do not receive deposits and, therefore, are not treated as banks under Internal Revenue Service rulings. Nor are these banks allowed any different net operating loss carrybacks than regular corporations. In other words, they are allowed a 3-year carryback and a 5-year carryforward of net operating losses.

General reasons for change.—It was suggested to the committee that the 13 banks for cooperatives be permitted the same deductions for additions to reserves for bad debts as are available to banks. The problem with giving the banks for cooperatives the bad debt reserve treatment available for commercial banks is that to date they apparently have had no bad debts, since their customers, the cooperatives, have apparently met all their payments. On the other hand, it is, of course, possible that in the case of a downturn in the economy at some future time, substantial losses might occur. The committee believes these situations could be provided for by allowing these banks a 10-year net operating loss carryback. This would appear to provide adequately for any bad debts which these banks might sustain.

Explanation of provision.—For the above reasons, the committee amendments provide that banks for cooperatives (as defined in section 2 of the Farm Credit Act of 1933) are to be allowed a 10-year net operating loss carryback, in addition to the 5-year carryforward now available.

The House bill did not contain a comparable provision.

Effective date.—This provision is to apply with respect to net operating losses sustained in taxable years beginning after the date of enactment of the bill.

6. Deduction of Recoveries of Anitrust Damages, Etc. (sec 906 of the bill and sec. 186 of the code)

Present law.—Taxpayers often recover substantial damages due to a patent infringement, a breach of fiduciary duty, or an antitrust injury to which section 4 of the Clayton Act applies. Sometimes these recoveries occur many years after the injury was sustained and are includable in taxable income at this subsequent time when actually received.

General reasons for the change.—Difficulty arises from the fact that the original losses may have resulted in no income tax benefit because, due to insufficient income from other sources, the net operating loss carryovers expired before it was possible to offset them against other income. As a result, in some cases taxpayers are required to include damages in income although the losses which they replace may not have resulted in a tax benefit.

Explanation of provision.—The committee amendments provide that, in the case of losses resulting from a patent infringement, a breach of fiduciary duty, or antitrust injury for which there is a recovery under section 4 of the Clayton Act, a special deduction is to be allowed which has the effect of reducing the amounts required to be included in income to the extent that the losses to which they relate did not give rise to a tax benefit.

This is accomplished under the committee amendments by providing that when a "compensatory amount" is received or accrued during a year for a "compensable injury," a deduction is to be allowed for the "compensatory amount" or, if smaller, the unrecovered losses sustained as a result of the "compensable injury." Compensable injuries are those sustained as a result of a patent infringement, a breach of contract or a breach of fiduciary duty or an antitrust injury for which there is a recovery under section 4 of the Clayton Act.

As indicated previously, the deduction is limited to the unrecovered losses resulting from the compensable injury if this is smaller than the total "compensatory amount." The unrecoved losses are the net operating losses attributable to the compensatory injury reduced by those allowed as a deduction as a loss carryback or carryover. These net operating losses are also reduced by the amount (if any) of a recovery of a compensatory amount in any other years against which these losses were offset.

The second limitation on the deduction is the "compensatory amount." This is the amount received as damages either as an award in or settlement of a civil action for recovery of a compensable injury. This is to be reduced by the expenses in securing the award or settlement. The provision, of course, applies only to recoveries for actual injury and not for any additional amounts.

There is no comparable provision in the House bill.

Effective date.—The amendments made are to apply to compensatory amounts received in taxable years beginning after December 31, 1968.

Revenue effect.—It is not believed that the revenue effect of this provision will be substantial.

7. Corporations Using Appreciated Property to Redeem Their Own Stock (sec. 907 of the bill and sec. 311 of the code)

Present law.—Present law (sec. 311 of the code) provides, in general, that gain or loss is not recognized to a corporation if it distributes property with respect to its stock.

General reasons for change.—Recently, large corporations have redeemed very substantial amounts of their own stock with appreciated property and in this manner have disposed of appreciated property for a corporate purpose to much the same effect as if the property had been sold and the stock had been redeemed with the proceeds of the sale. The appreciation is not taxed however, on this type of disposition.

This device has been used extensively by insurance companies which have large investment portfolios of stock of other companies acquired some time ago at prices appreciably below present values. They have been buying back their own stock through a general offer to their shareholders to exchange stock for their portfolios investments. The Internal Revenue Service has ruled such exchanges to be tax free to the insurance company.

The committee does not believe that a corporation should be permitted to avoid tax on any appreciated property (investments, inventory, or business property) by disposing of the property in this manner.

Explanation of provisions.—The committee amendments provide that if a corporation distributes property to a shareholder in redemption of part or all of his stock and the property has appreciated in value in the hands of the distributing corporation (i.e. the fair market value of the property exceeds its adjusted basis), then gain is to be recognized to the distributing corporation to the extent of the appreciation. This provision applies to any redemption of a shareholder's stock whether or not the redemption is classified as a dividend. On the other hand, the provision does not apply to a complete or partial liquidation of a corporation.

There is no comparable provision in the House bill.

Effective date.—The amendments made by this provision are to apply with respect to distributions after October 9, 1969 in taxable years ending after that date.

Revenue effect.—This provision will prevent the loss of substantial revenue which would occur in the future if there were to be a substantial expansion of practice now beginning of buying stock with appreciated property.

8. Reasonable Accumulations by Corporations (sec. 908 of the bill and sec. 537 of the code)

Present law.—Present law imposes a special tax on accumulated earnings of a corporation when the earnings are accumulated to save the individual shareholders from the tax on dividends which would have been incurred by them if the earnings had been distributed.

A corporation is not subject to this tax, however, to the extent the earnings were accumulated to meet the reasonable needs of the business, including the reasonably anticipated needs of the business.

Elsewhere present law (sec. 303) provides that a redemption by a corporation of stock included in the estate of a deceased shareholder is not treated as a dividend to the extent the amount used in the redemption is no greater than the estate tax plus the funeral and administration expenses. This provision applies, however, only if the stock of the corporation in question is more than 35 percent of the gross estate or more than 50 percent of the taxable estate. (The section is also applicable in certain cases when the percentage requirements are met by the stock of two or more corporations and the decedent's estate owns more than 75 percent of the stock of each corporation).

In addition, this bill adds a provision to the effect that a private foundation must dispose of all the stock it owns in excess of "permitted holdings." In the case of foundations which now own substantial amounts of stock in a corporation, "permitted holdings" are defined as 50 percent of the stock reduced by the percentage of stock owned by "disqualified persons" (that is, related parties). In addition, the bill provides that although generally there can be no dealing between the foundation and a corporation in which related parties have substantial interests, over a transition period stock can be redeemed in the type of case described above without this being classified as prohibited self-dealing.

General reasons for change.—Where there is a redemption of a large block of stock from a shareholder (whether or not to pay death taxes) the question arises as to whether the money accumulated to pay for the stock redeemed was accumulated for the reasonable needs of the corporation's business. If it was not so accumulated, the corporation becomes subject to the accumulated earnings tax (sec. 531).

It would appear that the same question will arise when a corporation redeems a large block of stock from a foundation in order to enable the foundation to bring its holdings down to the amount permitted by the bill.

The Internal Revenue Service sometimes has taken the position that any large redemption of stock indicates that the corporation had funds available for noncorporate purposes and therefore this is evidence that earnings were accumulated beyond the reasonable needs of the business. The courts have decided this issue in favor of the Service in a number of cases.

The committee believes that amounts accumulated in the year of the death and later years to redeem stock in a redemption to pay death taxes (sec. 303), as well as amounts accumulated to redeem stock which constitutes an excess business holding in the hands of a foundation should not be considered unreasonable accumulations. To consider them as such would substantially interfere with the purpose of these two redemption provisions.

Explanation of provision.—The committee amendments provide that the reasonable needs of the business (sec. 537) are to include amounts needed (or reasonably anticipated to be needed) in the year of death and later years to redeem stock to pay death taxes (sec. 303). The committee amendments also provide that the reasonable needs of the business include the amounts needed (or reasonably anticipated to be needed) to redeem from private foundations stock held on October 9, 1969 (or received pursuant to a will or irrevocable trust treated as binding on October 9, 1969) which constitutes an excess business holding.

The committee amendments also provide that in determining whether an accumulation is in excess of the reasonable needs of the business for a particular year, the fact that one of two special exceptions applies in a subsequent year and the accumulated funds are used for such a redemption, is not to give rise to any inference that the accumulation would not have been for the reasonable needs of the business in the absence of any such provision. In other words, any determination of the reasonableness of an accumulation is to be made without considering that the funds were subsequently used for either of these types of redemptions.

Effective date.—The amendments made are to apply to the tax on accumulated earnings with respect to taxable years ending after October 9, 1969.

Revenue effect.—It is believed that the revenue effect of these provisions will be negligible.

9. Special Contingency Reserves of Insurance Companies (sec. 909(a) of the bill and secs. 805(e)(4) and 810(c) of the code)

Present law.—Under present law, amounts set aside by a life insurance company in policyholder reserves are deductible in computing the income of the insurance company which is subject to tax. The amounts which are deductible in this regard include not only additions to life insurance reserves, but also, among other things, interest paid on indebtedness and amounts in the nature of interest. Present law also includes in these deductible amounts, interest on special contingency reserves established under the Federal Employees Group Life Insurance Act of 1954.

General reasons for change.—Amounts set aside in policyholder reserves have long been deductible in computing the income of life insurance companies which is subject to tax. This was true before 1959 when essentially the only income taxed to the life insurance companies was their investment income and since 1959 when not only investment income but also underwriting income has been taxed. As indicated above, the amounts deducted in this respect have included not only amounts added to what are called life insurance reserves but also, among other items, interest paid on indebtedness and amounts in the nature of interest on insurance or annuity contracts which do not involve, at the time of the accrual, life, health or accident contingencies. At the time this latter provision was added to the Code in 1942, the Congress in its committee reports indicated that this provision was to be interpreted broadly. It said that the provision includes amounts in the nature of interest such as so-called excess-interest dividends and guaranteed interest but Congress did not restrict the provision to only these items. In 1959 when the tax treatment of life insurance companies was substantially revised and broadened, this provision was nevertheless carried over substantially unchanged from the prior law and again Congress indicated that it was to be interpreted broadly. It said, for example, that this category includes interest paid on supplementary contracts and policyholder dividends left to accumulate, but again Congress did not limit it to merely these amounts.

The problem has arisen, however, as to the proper interpretation of present law in the case of certain special contingency reserves which are maintained by life insurance companies under group contracts. Life insurance companies maintain two types of so-called special contingency reserves under group life and group accident and health insurance contracts. One type of these reserves is used to fund over an employee's working life the cost of providing him group term life or group health and accident insurance after retirement. The second type of reserve is used for premium stabilization purposes, that is, to meet unusually large current claims which would otherwise require an increase in the premium payments of employers for the insurance coverage provided their employees. In some instances, the reserve is a combination of both types.

The problem with regard to the treatment of these reserves apparently has arisen because of the inclusion in present law of the specific provision regarding special contingency reserves established under the Federal Employees Group Life Insurance Act (FEGLI). At the time of the 1959 life insurance company tax legislation, the reserve under the FEGLI contract was called to the attention of this committee. The committee decided to add a specific provision dealing with the deductibility of interest on FEGLI reserves to the Internal Revenue Code (section 805(e)(4)). At that time a draft was prepared which would also have specifically provided for special contingency reserves under plans other than FEGLI. The final version of section 805(e)(4), however, was limited to FEGLI reserves because the earlier draft was considered cumbersome and, in any event, was thought to be unnecessary since even the FEGLI amendment was intended only to clarify the status of these reserves.

The fact that this was the congressional intent is specifically indicated in the Finance Committee report, in Senator Harry Byrd's explanation of the Senate Finance Committee amendments, and in Senator Frank Carlson's explanation, on behalf of Senator Byrd, of the conference committee's action. The report and both of these statements indicate that section 805(e)(4) was adopted "to make it clear" that a deduction was available to insurance companies for interest credited to the special contingency reserves. In other words, in the 1959 legislation it was assumed by this committee and by Congress that deductions were available in any event for interest credited to the special contingency reserves.

These special contingency reserves are policyholder reserves and must be used to provide insurance coverage for retired employees of the policyholder or to stabilize the policyholder's premiums under the policy. In other words, these special reserves are of the same nature as other reserves held for policyholders which are deductible in arriving at the amount of the income of a life insurance company which is subject to tax. Thus, there should not be a different tax treatment of these special contingency reserves.

Notwithstanding the clear congressional intent with regard to the treatment of these reserves, however, the Internal Revenue Service does not feel it can effect this intent under present law. Accordingly, the committee has added an amendment to the House bill to make congressional intent in this regard more specific.

Explanation of provision.—The committee amendments revise section 805(e)(4) of present law (regarding interest on special contingency reserves under FEGLI contracts) to make this provision applicable to interest credited to any special contingency reserves under contracts of group term life insurance or group health and accident insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination of these two purposes. Thus, in computing the amount of their income subject to tax, life insurance companies are to be allowed to deduct interest credited to these types of special contingency reserves whether the reserves are established under FEGLI contracts, private employer contracts, or under other contracts with the Federal Government, such as the Servicemen's Group Life Insurance contract or the Federal Employees Health Benefits Act contract.

The committee amendments also make comparable changes under the phase II tax imposed on life insurance companies (i.e., the tax on gains from operations other than investment income).

Effective date.—Since the amendments made by this provision are declaratory of what Congress intended in present law, it is provided that the amendments are to be applicable as of the effective date of the Life Insurance Company Income Tax Act of 1959; namely, taxable years beginning after December 31, 1957.

10. Spinoffs by Life Insurance Company (sec. 909(b) of the bill and sec. 815 of the code)

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

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

Reasons for provision.—In the past three exceptions have been made to the rule that there would be phase III tax consequences in the case of a spinoff to shareholders of the stock of a subsidiary of a life insurance company.

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

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

3. In 1967 (Public Law 90–225) an exception was made with respect to the spinoff of the stock of a subsidiary corporation where the subsidiary also is a life insurance company. The amendment permits the spinoff without phase III tax consequences where a holding company owns at least 80 percent of the stock of a "first-tier" life insurance subsidiary which in turn owns at least 80 percent of the stock of a "second-tier" life insurance subsidiary. In such a case, a distribution to the parent holding company of the stock of the second-tier subsidiary, where the distribution is otherwise tax free, is not to give rise to phase III tax consequences for the first-tier life insurance company if it has owned at least 80 percent of the stock of the second-tier life insurance company at all times since December 31, 1957. To the extent there were contributions to the capital of the second-tier company after December 31, 1957, these amounts are to be subject to phase III tax consequences on the spinoff of its stock.

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

The second-tier ordinary business subsidiary in the case brought to the committee's attention has been owned by the life insurance company since before the enactment of the Life Insurance Company Income Tax Act of 1959 and for that reason the distribution would not remove funds from the possible application of the phase III tax which were accumulated since the passage of that act. However, the removal of any assets, whenever or however acquired, from the possible application of the phase III tax does lessen the certainty of the ultimate payment of this tax by the life insurance company. This problem is particularly important where it is other than an insurance company which is being spun off since in such cases the assets cannot be expected to be held for use in an insurance company and could be sold, or distributed to shareholders, without the application of a phase III tax.

In view of the above considerations, the committee has added an amendment to the House bill which would permit the spinoff of a second tier ordinary business subsidiary to the parent holding company without the application of phase III tax consequences at that time, but which is designed to preserve the potential application of a phase III tax.

To accomplish this result, the amendment provides that the phase III tax is to continue to apply in such a case to the full extent, and in the same manner, as if the spinoff had not been made and the distributions to the parent company were therefore channeled to it through the life insurance company. As a result, any distributions made by the ordinary business subsidiary are to be treated as reducing the shareholders surplus account or the policyholders surplus account (as the case may be) of the life insurance company to the full extent of the distribution and thus are to give rise to a phase III tax in all cases in which a distribution by the life insurance company would give rise to a phase III tax. The sale (or other disposition) of the stock of the ordinary business subsidiary by the parent holding company also is to be treated as reducing the shareholders surplus account or policyholders surplus account of the life insurance company. These effects are limited to the amount of the fair market value of the stock of the ordinary business corporation at the time of the spinoff.

This provision is identical (except that the effective date covers 1969 and subsequent years rather than 1968 and subsequent years) to a provision approved by the Senate in 1968 as an amendment to H.R. 2767.

Explanation of provision.—This provision applies in cases where a life insurance company which at all times since December 31, 1957, has owned all the stock of a business subsidiary distributes the stock to a parent company which immediately after the distribution owns all the stock of both the life insurance company and the business subsidiary. In such a case, a distribution to the parent holding company of the stock of the business subsidiary by the life insurance company which is tax-free (under sec. 355) is not to reduce the life insurance company's shareholders or policyholders surplus accounts and thus give rise to phase III tax consequences, except to the extent of its post-1957 contributions to capital of the business subsidiary.

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

Effective date.—This amendment applies to taxable years beginning after December 31, 1968.

11. Loss Carryover of Insurance Company on Change of Form of Organization or Nature of Insurance Business (sec. 909(c) of the bill and sec. 844 of the code)

Present law.—Under present law the rules governing the income tax treatment of insurance companies differ somewhat depending on the form of the companies' organization (stock or mutual) and the nature of the companies' insurance business (life, casualty, etc.). An insurance company which incurs losses during periods when it is subject to tax under one set of rules in the past has not been able to carry these losses forward and deduct them (as it could if its status had not changed) during periods in which the company is subject to tax in a different status.

General reasons for change.—The limitation on the use of losses by insurance companies has been provided in the past primarily because, given the different ways of computing income or loss for different types of insurance companies, a loss of one type of organization carried over to a period when it is taxed as another type might result in too generous treatment. For instance, until 1962 mutual fire and casualty insurance companies were not taxed on their underwriting income and conversely were not permitted to deduct their underwriting losses. Since 1962, however, losses of all types of insurance companies are taken into account for tax purposes, and it is no longer appropriate to continue to prevent losses from being carried over when an insurance company shifts from one set of tax rules to another. As a matter of fact, denying the deduction of a loss carryover in this manner inhibits an insurance company from engaging in transactions in which it would otherwise engage. The committee sees no reason for this if the company, in changing its form of organization or the nature of its insurance business, does not receive a more favorable operating loss carry forward than it would receive in the case of either type of organization.

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

This amendment is identical to a provision approved by the Senate in 1968 as an amendment to H.R. 2767 of the 90th Congress.

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

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

12. Mutual Funds Under Periodic Payment Plans (sec. 910 of the bill and sec. 851(f) of the code)

Present law.—A mutual fund plan sponsor is an underwriter which sponsors a periodic payment plan for the accumulation of mutual fund shares by small investors. Under such a plan each investor makes regular monthly payments to accumulate shares of a specific designated mutual fund. The payments are made to a bank custodian which buys the shares of the issuing fund from the fund and holds them in its own name for the respective accounts of the investors. There are nearly 2 million small investors using these plans.

Under present law, the Internal Revenue Service treats a group of periodic payment investors subscribing to a particular plan as "an association taxable as a corporation" because the bank serving as custodian is regarded under S.E.C. rules as if it exercised centralized managerial powers for the investors (like the president and board of directors of a corporation).

General reasons for change.—In practice, since the bank custodian can only purchase shares of a single specified mutual fund, it does not exercise managerial discretion but performs ministerial functions in much the same manner as a brokerage office holding securities in its own name for a particular customer. However, treating the plan as a corporation may result in significant adverse treatment of the investors. Thus, if an investor asks for his stock and it is delivered to him individually, gain or loss may be recognizable on this transaction although the investor merely has taken down his own shares.

Explanation of provision.—The committee amendments add a provision (sec. 851(f)) to the regulated investment company provisions to provide that a periodic payment plan is not to be treated as a corporation, partnership or trust and that instead the mutual fund shares are to be treated as owned directly by the investor with the bank custodian acting as a nominee.

The new provision does not apply in the case of a unit investment trust (or a management-type of investment company) which is a segregated asset account under the insurance laws or regulations of a State. Where these accounts hold assets pursuant to variable annuity contracts, the account is taxed as part of the life insurance company. In addition, the provision added by the committe amendments is not intended to apply to other unit investment trusts where the assets are treated as part of the assets of the sponsoring life insurance company for purposes of State insurance laws, but where the assets are not held subject to variable annuity contracts. Under present law, trusts of this type may be classified as associations taxable separately from the life insurance company and may elect to be taxed as regulated investment companies under subchapter M. It is not intended by this amendment to change the tax treatment of these trusts taxed as associations. In other words, it is intended that this type of unit investment trust will continue to be taxed as an association and distributions in redemption of interests in it are to continue to be treated as at present.

Effective date.—The amendments made are to apply to taxable years of unit investment trusts ending after December 31, 1968, and to taxable years of holders of interests in these trusts ending with or within the taxable years of such trusts.

Revenue effect.—The amendments made by this provision are expected to have a negligible effect on revenues.

13. Exclusion For Income Earned Abroad (sec. 911 of the bill and sec. 911 of the code)

Present law.—Under present law an individual citizen of the United States who is a bona fide resident of a foreign country or who is temporarily abroad for a period of 17 out of 18 consecutive months is allowed an exclusion from his U.S. tax base for earned income from sources outside the United States. This exclusion is limited to $20,000 a year in the case of an individual who is temporarily abroad for 17 out of 18 months and in the case of an individual who has been a bona fide resident of a foreign country for less than three consecutive years. The amount of the exclusion is increased to $25,000 a year after an individual has been a bona fide resident of a foreign country for an uninterrupted three-year period.

General reasons for change.—The earned income exclusion was originally enacted to provide a special inducement for American citizens to hold employment abroad. Over the years the amount of the exclusion has been reduced in view of the decreasing necessity to provide this special inducement. The improvement in living conditions abroad and the increased benefits which employers often make available have lessened the need for the Government to provide an inducement in the tax system for American citizens to seek employment abroad.

The exclusion allows American citizens living abroad to have an appreciably lower tax rate than citizens living in the United States. Although there are some services which may not be provided for U.S. citizens living abroad to the same extent as for those living at home, there are other services which are used to a greater degree by citizens living abroad. Moreover, a U.S. citizen living abroad is likely to return to the United States upon retirement and at that time receive many of the services provided domestically when he is paying little or no Federal income tax.

Sometimes it is argued that citizens living abroad should not be taxed by the United States since their income is likely to be taxed by the foreign country in which they reside. To the extent this is true, however, the double taxation of their income is prevented by the foreign tax credit which the United State allows. Moreover, there are cases where the foreign country, although it taxes income when received in that country, does not tax it where arrangements are made for the citizen to have the funds deposited for him in the United States.

Explanation of provision.—For the above reasons, the committee amendments reduce the present ceilings on the earned income exclusion allowed U.S. citizens with respect to earned income from foreign sources to $6,000 a year. Under the committee amendments no distinction is to be made with reference to the length of time an individual has been a bona fide resident of a foreign country. Accordingly, a uniform $6,000 per year exclusion is to be available to individuals who have been bona fide residents of a foreign country for at least an entire taxable year and to individuals who are temporarily abroad for a period of at least 17 out of 18 consecutive months.

Effective date.—The amendments made by this provision are to apply with respect to taxable years beginning after the date of enactment of the bill.

Revenue effect.—It is estimated that this provision will result in an annual revenue increase of $25 million.

14. Foreign Base Company Income (sec. 912 of the bill and sec. 954(b)(4) of the code)

Present law.—Under present law, U.S. shareholders of a controlled foreign corporation are taxed currently on certain income earned abroad by the corporation, including what is termed "foreign base company income." Foreign base company income includes foreign personal holding company income, foreign base company sales income (generally income from the sale of property produced in the United States or a foreign country by one corporation and sold by a related corporation organized in another country for use outside that country), and foreign base company services income. Basically, this provision is designed to prevent the avoidance of tax by the diversion of sales or other types of income to a related foreign corporation which is incorporated in a country that imposes little or no tax on this income when it is received by that corporation since it arose in connection with an activity taking place outside of that country.

Present law provides an exception from this provision for an item of income where it is established to the satisfaction of the Secretary of the Treasury or his delegate that the creation or organization of the controlled foreign corporation in the foreign country in which it is incorporated does not have the effect of a substantial reduction of income or similar taxes with respect to that income.

General reasons for change.—Cases have come to the attention of the committee where controlled foreign corporations have substantial investments in the foreign country in which they are organized which they must dispose of because of the laws of the foreign country relative to permissible investments of foreigners. If that foreign country imposes little or no capital gains tax, then the exception in present law is not available with respect to the gain on the sale of the investments since there is a reduction of income taxes (relative to the tax which would have been paid in the United States were the transaction to occur here). This is true even though the corporation was not organized to reduce taxes and the purpose of the sale is to comply with foreign laws and not to reduce taxes.

These cases have led the committee to reexamine the exception contained in present law which focuses only on the question of whether there is a reduction of taxes. The committee believes it would be more appropriate for the availability of the exception to depend on whether the controlled foreign corporation was established in a given foreign country, and the transaction giving rise to the income was effected through that corporation, for the purpose of reducing income taxes. Accordingly, the committee has added an amendment to the House bill to revise the present exception from foreign base company income in this manner.

Explanation of provision.—The committee amendments provide an exception from foreign base company income treatment to the effect that a controlled foreign corporation's foreign base company income is not to include any item of income received by the corporation if two factors are established to the satisfaction of the Secretary of the Treasury or his delegate. First, it must be established that the creation or organization of the corporation under the laws of the particular foreign country did not have as one of its significant purposes a substantial reduction of income or similar taxes. If the taxpayer acquired a corporation which had previously been organized in a particular foreign country, then it would have to be established that the acquisition of a corporation created in that particular foreign country did not have as one of its significant purposes a substantial reduction of income or similar taxes.

Generally, if the income-producing activity carried on by a foreign corporation takes place within the country in which it is created or organized, it will not be considered as having been established in that country to achieve a substantial reduction in income taxes. This would include, for example, a corporation engaged in a manufacturing operation within its country of incorporation. If it is determined that one of the significant purposes of creating or organizing a foreign corporation in a particular country was to achieve a substantial reduction of income taxes, then none of the income received by that corporation could qualify under the exception from foreign base company income provided by the committee amendments.

If it is established that substantial reduction of income taxes was not one of the significant purposes for creating the foreign corporation within a particular country, the taxpayer must further establish that the effecting through that foreign corporation of the transaction which gives rise to the income in question does not have as one of its significant purposes a substantial reduction of income taxes. For example, a foreign corporation engaged in a manufacturing operation within its country of incorporation normally would meet the first test described above. However, if that corporation also derived other types of income and one of the principal purposes of having the corporation receive that income was to achieve a substantial reduction of the income taxes imposed on the income, then the second test would not be met and the exception from foreign base company income treatment would not apply.

The exception from foreign base company income treatment provided by the committee amendments is to be available with respect to all of the three classes of foreign base company income; that is, foreign personal holding company income, foreign base company sales income, and foreign base company services income. Where a controlled foreign corporation receives an item of foreign base company income and it is believed the exception provided by the bill would be applicable with respect to the income, the U.S. shareholder of the corporation would indicate in the return filed with respect to the corporation, when filing his return, the amount of income involved and the reasons why it is believed the exception is applicable.

The application of the exception from foreign base company income provided by the committee amendments may be illustrated by the following example. A controlled foreign corporation is incorporated under the laws of a foreign country. In the past the controlled foreign corporation has organized a number of other corporations in that country to operate radio and television stations there. The purpose of establishing these other corporations was to form a centrally managed radio and television network. The controlled foreign corporation's stock interest in these other corporations ranges from 10 percent to 100 percent. By reason of its stock interests and for other financial or technical reasons, the controlled foreign corporation has exercised effective practical control over the other corporations. The controlled foreign corporation also has conducted several businesses in the foreign country for a number of years which are related to the communications network it was attempting to establish.

In 1969, the communications agency of the foreign country changes its policy and rules that foreign corporations may not own more than 10 percent of the stock of local communications corporations. Since the controlled foreign corporation is more than 50 percent owned by U.S. persons, it is treated by the communications agency of the foreign country as being subject to this new rule. Because of this policy change, the controlled foreign corporation sells all its shares of stock in the radio and television corporations in the foreign country and realizes capital gains on the sales which, however, are not taxed by the foreign country.

Under the exception from base company income treatment provided by the committee amendments, these gains would not be treated as foreign base company income. This is because the controlled foreign corporation was organized in the foreign country to actively engage in business in that country and because the acquisition and the sale of the stock of the radio and television corporations by the controlled foreign corporation (rather than by its parent corporation or an affiliated corporation) did not have as one of its significant purposes the reduction of income or similar taxes.

Effective date.—This provision is to apply to taxable years ending after October 9, 1969.

15. Deferral of Gain Upon the Sale of Certain Lower Income Housing (sec. 913 of the bill and sec. 1039 of the code)

Present law.—Under present law, where an individual sells his personal residence and reinvests the proceeds from this sale within a certain specified time in another personal residence, no gain is recognized on the sale of the first residence to the extent the proceeds are so reinvested. Instead, the basis of the second residence is reduced by the amount of gain not recognized with respect to the first residence, with the result that if the second residence is resold without the funds being reinvested in a third residence, the gain is generally realized at that time. Present law also provides for the nonrecognition of gain on a similar basis in the case of involuntary conversions of property and also in the case of "like-kind" exchanges. No deferral of the recognition of gain is available, however, under present law in the case of the sale of lower income housing held as rental property.

General reasons for change.—In the case of federally assisted housing projects (where the return to the investor is limited to approximately 6 percent), the Government is interested in encouraging the sale of these Government-assisted housing projects to the lower income occupants or to a tax-exempt organization which manages the property on their behalf (such as cooperatives and condominiums). The maximum sales price permitted under these programs under present law is the amount the individual has invested in the property plus an amount necessary to retire the outstanding mortgage liability and the taxes payable as a result of the sale. By providing that no gain is to be recognized in these cases, it would be possible to decrease the sales price to the occupants or tax-exempt organizations managing these properties. The committee believes this result would be desirable. This should enable them to make purchases they otherwise could not make.

Explanation of provision.—For the above reasons, the committee added an amendment to the House bill to permit a taxpayer who invests in a federally assisted lower income housing project (so-called FHA 221(d)(3) and 236 projects) to sell the property and pay no current tax on the gain involved where (1) he sells the property to the occupants or to a tax-exempt organization which manages the property, and (2) the full proceeds from the sale are reinvested in other federally assisted low-income housing projects which limit the investor's rate of return. In these cases, it is provided that no gain is to be recognized on the sale of the first project. The taxpayer's basis from the old property, to the extent the proceeds are reinvested in similar property, is to be carried forward and become a part of his basis for the new property. The holding period of the first property is to be taken into account in determining how long the new property is held, but only with respect to that part of the new property representing the amount of the sale proceeds of the first property which were reinvested in the new project.

Any investment in a new project in excess of the sales proceeds of the old project will have a holding period beginning with the acquisition of the new project. If only part of the proceeds from the sale of a qualified project is invested in a similarly qualified project, gain on the sale of the old project is to be recognized to the extent of the smaller of: (1) the excess of the proceeds from the sale of the old project over the amount invested in the new project, or (2) the gain realized on the sale of the old project. The basis of the new project is to be adjusted accordingly. In other words, the basis of the new project is to be the cost of the new project minus the realized gain which was not recognized from the sale of the old project.

Effective date.—This provision is to be effective with respect to sales made after October 9, 1969.

Revenue effect.—The loss of revenue from enactment of this provision is expected to be negligible.

16. Cooperative Per-Unit Retain Allocations Paid in Cash (sec. 914 of the bill and sec. 1382(b) of the code)

Present law.—Under present law, patronage dividends paid in money, qualified allocations, or other property may be paid to the patron within $8\frac{1}{2}$ months after the end of the year in which the earnings to which they relate arise. Where this occurs the cooperative is not taxed, but the patron is taxed on this amount in the following year when he receives the patronage dividend. Patronage dividends are amounts determined by reference to the net earnings of the cooperative from business done with, or for, its patrons.

Per-unit retain allocations, if paid in qualified per-unit retain certificates, also may be paid to the patron within $8\frac{1}{2}$ months after the end of the taxable year, with the cooperative receiving a deduction or exclusion for these amounts in the prior taxable year and the patron reporting these amounts as taxable income. However, this treatment is not available in the case of per-unit retain allocations paid in money or other property. Per-unit retain allocations are payments to patrons with respect to products marketed for them where the amount is fixed without reference to the net earnings of the organization. Usually the per-unit retain allocation is fixed on the basis of the number of units marketed with the cooperative.

General reasons for change.—Problems have arisen under present law where cooperatives desire to make cash payments to patrons with respect to cooperative pools, but cannot make them before the end of the year because their accounting records are not closed at that time. Patronage dividends often cannot be paid during the $8\frac{1}{2}$ month payment period following the taxable year because the net earnings of the pool cannot be determined until the pool is closed, which may occur much later. However, the payments can be made as per unit retain allocations if they are paid as qualified per unit retain certificates. The Code does not presently permit a deduction (or exclusion) in the prior taxable year for a direct payment of cash, as opposed to the issuance of per unit retain certificates during the payment period. There seems to be no reason why a cooperative should be able to deduct per unit retain allocations paid as qualified certificates during the $8\frac{1}{2}$ month period following the close of the taxable year, but not per unit retain allocations paid in money during the same period.

The committee understands that under Internal Revenue Service practice a qualified per-unit retain certificate may not be redeemed until at least 30 days after it is issued. The committee does not believe that any purpose is served by requiring a cooperative to follow this procedure, which results in a delay in the receipt of cash by the patrons and the additional administrative burden of issuing and redeeming certificates.

Explanation of provision.—The committee amendments provide that a cooperative can deduct or exclude from gross income per unit retain allocations whether they are paid in money (or other property) or in qualified per unit retain certificates.

No similar provision is contained in the House bill.

Effective date.—This amendment applies to per-unit retain allocations made after October 9, 1969.

AA. MISCELLANEOUS EXCISE TAX PROVISIONS

1. Application of Excise Taxes on Trucks to Concrete Mixers (sec. 931 of the bill and sec. 4063(a) of the code)

Present law.—Until 1967, the 10 percent excise tax on the manufacture of automobile trucks was not applied in the case of concrete mixers where the actual mixing of the concrete occurred in the tank mounted on a truck chassis. The truck chassis in such a case, however, is subject to the excise tax. In 1967 the Internal Revenue Service reversed its position with respect to concrete mixers mounted on truck chassis. At that time it concluded that these concrete mixers were not designed and adapted by the manufacturer for purposes predominantly other than the transportation of property on the highway.

General reasons for change.—Apparently the change in ruling policy stemmed from an exemption for seed, feed, and fertilizer spreaders added by Congress in 1965. In the committee report on that provision reference was made to the fact that these would not be taxable even though incidental highway use occurred. It was not the intent of Congress when it provided an exemption from the excise tax on automobile trucks for these purposes that the language used in connection with the provision for the exemption would result in the review of existing items not subject to tax, and the reclassification of them into a taxable status. Moreover, "incidental" in such a case was not intended to tax equipment where its highway transportation use was functionally incidental or subordinate to some nonhighway use—in this case, the mixing of concrete.

Explanation of provision.—The committee amendments provide an exemption from the manufacturer's excise tax on motor vehicles in the case of articles designed to be mounted on automobile truck, truck trailer, or semitrailer, chassis which are designed to be used to process or prepare concrete. In addition, an exemption is provided for parts and accessories designed primarily for use on or in connection with these concrete mixers.

No comparable provision appears in the House bill.

Effective date.—This amendment is to apply to articles sold after June 30, 1968.

2. Constructive Sales Price (sec. 932 of the bill and sec. 4216 of the code)

Present law.—Present law (sec. 4216(b)) provides for a constructive sales price (as a substitute for the actual sales price) as a base for the various ad valorem manufacturers' excise taxes in several different types of situations. One of these involves the situation where the article is sold at less than the fair market price if the transaction is not at arm's length. Sales between related companies are examples of sales which are not considered to be at arm's length. As a result, in the case of a sale by a manufacturer or importer to its selling affiliate, a determination must be made as to whether the sale is at less than "fair market price," and where this is true, the appropriate constructive price must be determined by general standards. If industry data are available, the determination should properly be made by reference to the prices for which others in the same industry at the same level of distribution sell similar articles. Because of difficulties in obtaining what it considers to be adequate information as to selling practices and prices of various companies within an industry, the Internal Revenue Service has generally not made determinations of constructive sales prices by reference to sales by other companies.

In 1962, however, the Internal Revenue Service published a ruling providing for a constructive sales price where a manufacturer or importer (the party liable for the excise tax) sells his products at less than fair market price to a wholly owned sales subsidiary and the subsidiary resells to one or more independent wholesale distributors (Rev. Rul. 62–68, 1962–1 C.B. 216). This provided that the taxpayer could elect to treat the constructive sales price as being 95 percent of the lowest price for which the sales subsidiary resold the article to independent or unrelated wholesale distributors. The Service has also held that where a manufacturer or importer makes sales to a wholly-owned selling subsidiary at a price less than the fair market price, and the wholly-owned selling subsidiary resells the articles to independent retailers but does not regularly sell to wholesale distributors, the constructive sales price is to be 90 percent of the selling subsidiary's lowest price to independent retailers.

General reasons for change.—In those industries where the pricing policies of competitors on any broad basis are difficult to determine with certainty, the ruling policy of the Internal Revenue Service has been of help. It acknowledges that the price at which the selling company sells, either to wholesalers or to retailers, overstates the price at which the affiliated manufacturer or importer could be expected to sell to the selling company. However, where information as to the selling prices of others in an industry can be obtained, this information may well indicate that where most sales are to retailers, the 10 percent markdown is inadequate.

Explanation of provisions.—The committee's amendments add two constructive price rules to the tax laws dealing with situations where a manufacturer or importer regularly sells an article subject to excise tax to an affiliated corporation and that corporation regularly sells these articles to independent retailers but does not regularly sell to wholesale distributors. The first of these rules is the 90 percent rule described above. The second rule provides a method for determining the fair market price in the case of such sales to a selling affiliate by reference to the markups of others in the same industry who normally sell to independent distributors.

The first rule provides that the fair market price of the article is to be 90 percent of the lowest price for which the subsidiary corporation regularly sells the article in arm's length transactions to independent retailers. The second rule provides that where the distributor regularly sells only to retailers and the normal method of sales in the industry is by arm's length transactions to distributors, then the fair market price of the article is to be the price at which the article is sold to retailers by the affiliated distributor, reduced by a percentage equal to the markup used by independent distributors in that industry.

This latter rule, in effect, allows a manufacturer to establish a fair market price on its products with the opportunity for the Service to comment on the adequacy of this determination under the guidelines set forth.

This amendment does not attempt to cover all situations where a manufacturer or importer sells to an affiliated company but only to codify and clarify present law with respect to the more common situations discussed above. In other situations, such as a sale by a wholly-owned manufacturing corporation to its parent corporation which, in turn, regularly resells to independent wholesale distributors, as well as at retail, the fair market price would continue to be determined under the existing constructive price provisions.

In computing a sales subsidiary's lowest price to independent parties, this price should be determined in the same manner as if the price were in a taxable sale. This price should be, for example, the net price to the purchaser after taking into account trade discounts given by the seller as a result of contractual arrangements existing at the time of the sale. Also, it is not required that the sales subsidiary make any given percentage of its sales at a particular price in order for these to be the lowest price so long as the sales are bona fide arm's length transactions regularly engaged in with unrelated parties. Moreover, where sales are made both including and excluding transportation charges, the lowest price would be the price excluding the transportation charge.

There is no comparable provision in the House bill.

Effective dates.—These amendments apply to articles sold on or after January 1, 1969.

Revenue effect.—It is believed that the revenue effect of these provisions will be negligible.

BB. MISCELLANEOUS ADMINISTRATIVE PROVISIONS

1. Filing Requirement for Individuals (sec. 941 of the bill and sec. 6012(a) of the code)

Present law.—Under present law an individual is required to file a tax return if his gross income is $600 or more unless he is age 65 or over, in which case he is required to file a tax return if his income is $1,200 or more.

General reasons for change.—With the introduction of a low-income allowance which raises the nontaxable level for a single person to $1,700 and for a married couple to $2,300, the existing filing requirements would result in a substantial amount of unnecessary filing of returns by those not subject to tax. This would cause an appreciable amount of paper work both for the taxpayers and the Internal Revenue Service.

Explanation of provision.—The committee amendments raise the income level at which a tax return must be filed to $1,700 for a single taxpayer, $2,300 for a married couple (or a single person age 65 or over), $2,900 in the case of a married couple where one spouse is age 65 or over and $3,500 in the case of a married couple where both spouses are age 65 or over. For married couples, these higher filing requirements are applicable only if they have the same household as their home at the end of the year. They are not applicable if either spouse files a separate return or if any other taxpayer is entitled to an exemption for either spouse. This latter rule is a reflection of the present law provision which prohibits a taxpayer from claiming an exemption on his return for someone who files a joint return. The filing requirement would remain at $600 for married couples filing separate returns.

The House bill did not contain a provision dealing with the filing requirement.

Effective date.—The changes in the filing requirement are to apply to taxable years beginning after December 31, 1969.

2. Computation of Tax by Internal Revenue Service (sec. 942 of the bill and sec. 6014 of the code)

Present law.—Presently taxpayers may request the Internal Revenue Service to compute their tax only if their gross income is less than $5,000, they take the standard deduction, use the optional tax table and do not have non-wage income in excess of $100. The tax in this case does not take account of whether the taxpayer is a head-of-household or surviving spouse and does not take into account the retirement income credit.

General reasons for change.—The committee believes that the present limitations on the type of taxpayer who may elect to have his tax computed for him by the Internal Revenue Service are unnecessarily restrictive. The elimination of these restrictions will permit the Internal Revenue Service to extend substantially its program of assistance to taxpayers.

Explanation of provision.—The committee amendments raise from $5,000 to $7,500 the income level up to which the Internal Revenue Service will compute income tax if requested and provide that head-of-household or surviving spouse status is to be taken into account for the tax computation. In addition, the Secretary of the Treasury in regulations is to outline the conditions under which a taxpayer may request the Internal Revenue Service to compute his tax. These regulations may provide that the Internal Revenue Service will compute the tax regardless of the source of the taxpayer's gross income, regardless of whether it is $7,500 or more, regardless of whether he itemizes his deductions or takes the standard deduction, and without regard to whether he claims the retirement income credit.

A provision in the House bill would have made the present restrictions inapplicable.

Effective date.—This provision is to apply for taxable years beginning after December 31, 1969.

3. Penalties for Failure to Pay Tax or Make Deposits (sec. 943 of the bill and secs. 6651 and 6656 of the code)

Present law.—Under present law, in the case of a failure to pay income tax when due, simple interest at 6 percent, payable annually, must be paid on the unpaid amount. Present law also provides a 5 percent per month penalty, up to a maximum of 25 percent, on the amount required to be shown on a return (less amounts already paid) if a taxpayer fails to file a return on the date it is due, unless the failure is due to reasonable cause and not to willful neglect.

Under present law interest is also due at the statutory 6 percent rate on unpaid deficiencies. In the case of failure to make deposits of taxes when due, a penalty is imposed of 1 percent per month, not exceeding 6 percent in the aggregate.

General reasons for change.—Since the current cost of borrowing money is substantially in excess of the 6 percent interest rate provided by the code, it is to the advantage of taxpayers in many cases to file a return on the due date but not to pay the tax shown as owing on the return. For the period the tax remains unpaid, the taxpayer is, in effect, borrowing from the Government the amount of the tax at a 6 percent rate of interest.

Similar borrowings can result from failure to pay deficiencies or to make deposits of taxes.

Although full information is not available, borrowings of this type may be occurring on a substantial scale.

Explanation of provision.—The committee amendments provide a penalty for failure to pay income tax (other than estimated tax) when due, and for failure to pay a deficiency within 10 days of the date of notice and demand. As in the case of failures to file returns under present law, the penalty is to be 5 percent of the amount of the tax if the failure is for not more than one month, with an additional 5 percent for each additional month, or fraction thereof, during which the failure continues, not exceeding 25 percent in the aggregate. In the case of failure to pay income tax when due, the penalty is imposed on the amount shown on the return as due, less amounts that have been withheld, estimated tax payments, partial payments, and other applicable credits. The penalty is not to be imposed if it is shown that the failure to pay the tax or the deficiency is due to reasonable cause and not to willful neglect. In the case of failure to pay a deficiency within 10 days of the date of the notice and demand, the penalty is imposed on the tax stated in the notice reduced by the amount of any partial payments.

In the case of a late filing, the penalty remains as under present law.

The committee amendments also provide that if with respect to any return an addition to tax applies both for failure to file the return on the due date and for failure to pay the tax on the due date, or failure to pay a deficiency within 10 days of the date of notice and demand therefor, the addition for failure to file is to be allowed as an offset against the other addition. If the amount required to be shown as tax on a return is more than the amount actually shown, the addition for failure to pay the tax, but not the addition for failure to file the return when due, is to be computed only on the amount shown.

With respect to failure to make deposits of tax, the amendment changes the 1 percent per month penalty to a flat 5 percent penalty.

Effective date.—With respect to payment of tax shown on a return and payment of deficiencies, the amendment is to apply with respect to returns due after December 31, 1969, and deficiencies the notice and demand for payment of which is made after December 31, 1969. With respect to making of deposits, the amendment is to apply to deposits required to be made after December 31, 1969.

4. Reporting of Medical Payments (sec. 944 of the bill, sec. 6050A of the code, and sec. 1122 of Title XI of the Social Security Act)

Present law.—Under present law every person making payments in the course of his trade or business to another person of rent, salaries, and a variety of other fixed or determinable gains, profits, and income amounting to $600 or more in a calendar year must file an information return showing the amounts paid and the name and address and identification number of the recipient.

Under Internal Revenue Service procedures in effect when the bill was ordered reported, information returns were not required of insurance companies (including those participating in Medicare), Blue Cross-Blue Shield organizations, State agencies participating in the Medicaid program, and employers and unions having self-insured or self-administered plans, when they made payments to doctors, dentists, and other suppliers of medical and health care services and goods on behalf of individuals. These organizations are now required by the Internal Revenue Service to make information returns with respect to payments to doctors and other suppliers.

General reasons for change.—Although these organizations are now required by the Internal Revenue Service to make information returns with respect to direct payments to doctors and other suppliers, there is no authority under existing law to require reporting by these organizations of payments made to the patients for services or goods furnished by the suppliers even though in normal circumstances they are paid over to the suppliers or represent reimbursements of earlier payments made by the patients.

The committee believes it desirable to provide specific rules requiring information returns to be filed with respect to payments in excess of $600 during the calendar year to suppliers of medical goods and services, whether the payments are made directly to the supplier or to the patient or other third party in reimbursement for payments to the supplier. To omit reporting of payments where they are not made directly to the supplier could encourage the use of indirect payments in order to avoid reporting for Federal income tax purposes.

Explanation of provision.—The committee has added to the bill a provision requiring the filing of an information return for payments of $600 or more made during the calendar year to a supplier of medical goods and services. The reporting requirement covers payments to doctors, dentists, and other suppliers of medical and health care services. It also covers payments for medical and health care goods and services such as medicines and orthopedic and prosthetic devices, and medicine and other goods and services rendered, furnished or dispensed by doctors, dentists, and other suppliers of medical services.

The requirement also applies to payments made to any person in reimbursement for amounts paid or payable to a supplier. For example, an insurance company must report as payment to a doctor an amount paid by it to a patient in reimbursement of amounts paid or payable to the doctor by the patient.

All payments, whether made directly to the supplier or to another person in reimbursement for amounts paid or payable to the supplier must be aggregated in determining the amount paid during the year.

The following exceptions from these requirements are provided:

(1) The reporting requirement does not apply to payments not made in the course of a trade or business. For example, the requirement applies to an insurance company that pays an insured patient's doctor bill for medical services or reimburses the insured patient for the amount of the doctor bill, but it does not apply to the patient himself when he pays a doctor, because he is not making the payment in the course of a trade or business.

(2) The provision does not apply to the payment of wages subject to withholding by an employer (with respect to which a statement is

made under section 6051), a payment to a tax-exempt organization described in section 501(c)(3), or a payment to an agency or instrumentality of the United States or a State or political subdivision of a State.

(3) The provision does not apply to payments for goods or services dispensed or supplied by a noninstitutional pharmacy.

(4) The reporting required does not apply to any payment to an individual by his attorney or agent, or to any payment made by a person with respect to which a return is made by any other person.

(5) In the case of a payment in settlement of a claim which includes reimbursement for amounts paid or payable to a supplier of medical and health care services or goods, reporting is required only to the extent that these amounts have been separately identified to the person making the payment. (The payment must contain determinable sums specifically attributable to identified persons.) For example, if a casualty insurer makes a lump sum settlement which encompasses not only medical expenses but also compensation for personal injuries or property damage, the medical expenses must be reported only to the extent they have been separately identified to the insurance company.

(6) In many cases, the amount of expenses for medical and health care goods and services is greater than the amount reimbursed by the insurance company. This may be the case, for example, where the insurance company reimburses only a specified percentage of medical expenses, or where no reimbursement is made for a fixed initial amount, such as $100. The bill gives the Secretary of the Treasury or his delegate regulatory authority to provide for the determination of the amount paid to each supplier in these cases where the reimbursement covers more than one supplier, and the payment does not separately state the amount paid in reimbursement of amounts paid or payable to each supplier.

The committee recognizes that the provisions requiring reporting of payments to persons in reimbursement for amounts paid or payable to suppliers will impose an additional burden on insurance companies and other organizations from whom reporting is required. However, the committee believes it is necessary to require reporting of these payments to prevent a shift to indirect payment of doctors and other suppliers which would undermine the effectiveness of the requirement that direct payments be reported. The committee expects that the Commissioner of Internal Revenue will work with the insurance industry and with other reporting organizations to devise methods of reducing the cost of complying with the new reporting requirements.

The committee also recognizes that amounts reported as payments to suppliers which are actually payments to other persons in reimbursement for amounts billed by suppliers will not always accurately reflect the actual income of the supplier. The committee anticipates that the amounts reported under this provision will be helpful to the Internal Revenue Service in selecting returns for audit and in providing background information with respect to the audit of returns of suppliers, but it does not intend that the reports be used as evidence in themselves of income received by the supplier.

The bill provides that the information supplied in the information return with respect to any person is to be furnished to that person on or before January 31 of the following calendar year. For example, if a separate form is supplied to the Internal Revenue Service with respect to each payee, a copy of the form is to be sent to the payee.

The bill also amends Title XI of the Social Security Act to require the Secretary of Health, Education and Welfare to provide for similar reporting with respect to Medicare and Medicaid payments. The Secretary is required to keep records showing the identity of each person who receives payments under Medicare and Medicaid programs, and under programs for maternal, child health, and crippled children services under Title V of the Social Security Act, and the aggregate amounts paid to the individual under each program. In order to carry out this requirement, the Secretary is given the authority to require information from all persons, agencies or agents administering or assisting in the administration of these programs. The suppliers are required to be identified by the identifying number required to be included in the information return.

The bill requires the Secretary of Health, Education and Welfare to submit to the Senate Committee on Finance and the House Committee on Ways and Means an annual report identifying each person paid a total of $25,000 or more during the preceding year under Medicare or Medicaid programs or programs for maternal, child health, and crippled children services under Title V of the Social Security Act. This report will facilitate the committees' exercise of their legislative responsibilities with respect to these programs.

Effective dates.—The provisions requiring reporting with respect to Medicare, Medicaid, and Title V payments, whether by the Secretary of Health, Education and Welfare or by private carriers and other organizations, are to be effective with respect to calendar years beginning after 1968. However, in the case of these payments made during 1969 to suppliers of medical and health care services and goods, the time for filing returns and for furnishing statements to the payee is the last day of the fourth month after the date of enactment of the bill. With respect to other payments, the bill applies to payments made on or after January 1, 1970.

CC. ARTICLE I STATUS FOR TAX COURT AND PROVISION FOR SMALL CLAIMS CASES

(Secs. 951–962 of the bill and secs. 7441–7487 of the code)

Present law.—The Tax Court of the United States is at present an independent agency in the Executive Branch of the Government. It is the forum to which taxpayers may take income, estate, and gift tax cases for redetermination of deficiencies (including a determination that there is not only no deficiency but that there is an overpayment) before paying the taxes. The sixteen judges of the Tax Court are appointed by the President with the advice and consent of the Senate for 12-year terms (an appointment to fill a vacancy in an existing term is only for the remaining period of the vacancy). The Court has no power to punish for contempt, not even for violations of subpoenas which it is authorized to issue.

The Court provides its own rules of procedure but must abide by the rules of evidence applicable to nonjury cases in the District Court of the District of Columbia. The Tax Court is required to have a stenographic transcript prepared of all its hearings, to prepare written reports of its opinions (including findings of fact), and to publish those reports.

Judges must retire after reaching the age of 70 if they have completed at least 10 years of service; they may retire after 18 years of service at any age. A noncontributory pension is available which entitles a judge to retire at full pay after 24 years on the Court or at proportionately lesser amounts where retirement occurs earlier. A judge who elects this noncontributory pension is not entitled to also receive a Civil Service pension even though rights to the Civil Service pension had accrued before he became a judge. Also, he is not entitled to receive back his Civil Service pension contributions if he elects to receive the Tax Court pension. Survivors benefits of Tax Court judges are funded by judges' contributions. Each judge must elect at one of certain specified times before he can provide survivors benefits for his dependents.

General reasons for change.—Two problems have arisen in connection with the Tax Court—the first is the need for special procedures for handling small claims and the second is the status of the Tax Court itself.

Many taxpayers with small claims believe they have no practical opportunity to present their claims before an impartial tribunal, and so they conclude they must abide by the decisions of the Internal Revenue Service. While the Tax Court procedures are less complicated in many respects than those of other courts, they remain formal in nature because the Court and the Internal Revenue Service must consider not just the amount involved in any particular case but also the precedent that it might provide for future cases. In addition, since decisions in these cases are subject to review in the appropriate Court of Appeals (and then, perhaps, in the Supreme Court), a complete record must be prepared of the proceedings in each case and the Court's findings of fact and opinion must be sufficiently detailed to permit a proper review. Although the Tax Court has instituted simplified procedures in small cases, formal rules of evidence often constitute a difficult barrier to the taxpayer who represents himself. The committee has concluded that taxpayers with small cases need to have practical access to the Tax Court.

Since the Tax Court has only judicial duties, the committee believes it is anomalous to continue to classify it with quasi-judicial executive agencies that have rulemaking and investigatory functions. The status of the Tax Court and the respect accorded to its decisions are high among those familiar with its work. However, its constitutional status as an executive agency, no matter how independent, raises questions in the minds of some as to whether it is appropriate for one executive agency to be sitting in judgment on the determinations of another executive agency.

Also, it seems inappropriate that the Tax Court is required to look to the District Courts to enforce its own authority.

Because a Tax Court judge, under present law, is first appointed for the remainder of his predecessor's term, his first appointment may well be for only two or three years or even as short a period as several months. A judge may be appointed at any age and would not be required to retire at age 70 unless he had already served for 10 years.

(Unless a judge served that long, he would not be eligible for a Tax Court retirement pension under present law.) The committee believes that Tax Court judges should have longer, more uniform terms, but should not serve past the age of 70 except under the limited circumstances pertaining to the recall of retired judges.

The Tax Court retirement provisions also are defective in several respects, for example, they do not authorize retirement for disability although this is available to District Court judges. Moreover, Tax Court judges are neither permitted to collect Civil Service retirement benefits if they elect Tax Court retirement nor are they permitted to receive back their contributions to the Civil Service retirement fund, even though District Court judges who have already achieved eligibility under Civil Service retirement are permitted to collect such benefits in addition to their pensions as judges or to receive refunds of their Civil Service contributions. Also, District Court pensions are far more favorable as a proportion of salary than are those available to Tax Court judges. Finally, the present provisions severely restrict the occasions when a Tax Court judge may apply for survivors benefits.

Explanation of provision.—The committee amendments are concerned with establishing a procedure whereby the taxpayers with relatively small claims may have reasonable access to the Tax Court without impairing the Court's ability to deal with the cases coming before it. The amendments are also concerned with making the Tax Court an Article I court rather than an executive agency and expanding its powers accordingly. Further, the Tax Court retirement and survivors provisions are revised to bring them more nearly in accord with those applicable to District Court judges.

The bill provides that in small cases (where neither the disputed amount of the deficiency nor the claimed overpayment exceeds $1,000 as to any one taxable year or to an estate tax)[1] a simplified and relatively informal procedure is to be available to taxpayers. In such a case the decision would be based upon a brief summary opinion instead of formal findings of fact, etc., would not be a precedent for future cases, and would not be reviewable on appeal. Moreover, the Court would not have the power to determine a deficiency or overpayment in dispute exceeding $1,000 for any taxable year or for an estate tax.[2] In addition, the Court would be given discretion as to the rules of evidence and procedure to be applied (leaving the Court with the freedom to adapt any small claims court rules that are appropriate) but with the expectation that the Court would follow relatively informal rules whenever possible.

Use of this procedure would be optional with the taxpayer unless the Tax Court (presumably upon the request of the Internal Revenue

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[1] This provides a special method for dealing with small cases that are already within the Tax Court's jurisdiction; it does not expand the categories of cases that the Court may hear.

[2] The Court would not be permitted to determine a deficiency more than $1,000 above the undisputed amount in the notice of deficiency. For example, if a deficiency of $1,200 were determined by the Internal Revenue Service and the taxpayer put in issue in the Tax Court only $300 of that deficiency, then the remaining $900 of the deficiency would have been conceded and the maximum deficiency that could be determined would be $1,900. (or $1,000 more than the deficiency already conceded but only if the government increases the deficiency it asserts by an additional $700 over and above the $300 initially at issue). Existing law would not be changed in that the Service would have the burden of proof as to the $700 above its original determination of deficiency. By the same token, once the taxpayer invoked the small claims procedure and the Tax Court concurred, he could not have the deficiency reduced below $200. However, as indicated below these limitations could be avoided in certain circumstances.

Service) decided before the hearing that the case involved an important tax policy issue which should be heard under normal procedures and should be subject to appeal. Commissioners may be used by the Tax Court in such cases and are to be paid at the same rate as Commissioners of the Court of Claims.

If it becomes evident to the Court during, or at the end of, the trial of a small claim case that the deficiency or overpayment should be increased by more than $1,000, then the Court has discretion to shift the case to the procedures for regular Tax Court cases. This discretion is expected to be exercised only in unusual cases, where the Court deems it appropriate, taking into account all considerations bearing on the fairness of the change, including the costs involved for all parties.

In establishing a small claims procedure the committee amendments are purposely broad to allow the Court latitude in setting up a small claims division so as to meet the varied and difficult problems, both substantive and procedural, which may arise. It is contemplated the Court will report its progress to the Congress from time to time.

The bill establishes the Tax Court as a court under Article I of the Constitution, dealing with the Legislative Branch.[3]

At the present time, the Court of Military Appeals is the only other Article I court. Other courts, however, have enjoyed this status in the past, including the Court of Claims. In accordance with this change, the Tax Court is given the same powers regarding contempt, and the carrying out of its writs, orders, etc., that Congress has previously given to the District Courts.

The method of appointment of judges to the Court (by the President with the advice and consent of the Senate) is not changed by the bill. However, the term of office is established as 15 years from the date the judge first takes office. A judge may not be appointed for the first time after reaching the age of 65. The amount and method of payment of the Tax Court judges' salaries are made identical with those of District Court judges.

The provisions regarding retirement are revised to require retirement at age 70, whether or not the judge has completed 10 years service by that time. The provisions of existing law authorizing the use of retired judges on recall to relieve heavy case loads are unchanged by the amendments.

As in the case of the District Court, the bill permits a judge to retire at age 65 if he has served at least 15 years, and to retire at a younger age with 15 years service if he is available for reappointment at the conclusion of his term but is not reappointed. The bill requires a Tax Court judge to retire if he is permanently disabled. In general, retirement under these provisions is to be at the full pay of the office.[4]

If the judge has served less than 10 years when he reaches the mandatory retirement age of 70, then his retirement pension is apportioned in accordance with the number of years he has served. If the judge has served less than 10 years and is retired because of disability,

[3] The limitations of Article III of the Constitution, relating to life tenure and maintenance of compensation, do not apply to Article I courts. The committee amendments do not place the Tax Court under the supervision of the Judicial Conference or the Director of the Administrative Office of the Article III courts or give them any power or control over the Tax Court.

[4] If the salary of Tax Court judges is changed at a later date, the salaries of retired judges are adjusted accordingly. This rule is in present law and is not changed by the bill.

then his pension is half the salary of the office. The disability provisions are patterned after those of District judges.

The bill retains the provisions of present law that a Tax Court judge may not receive both Civil Service retirement and Tax Court retirement pensions, but the judge is permitted to receive back any contributions he made to the Civil Service retirement fund if he elects the Tax Court pension. Under the committee's amendments, an election to provide for survivors' benefits may be made at any time the person is a judge instead of only at the specific times now set forth. The bill makes no change in the amounts the judge is required to contribute and no change in the level of survivors' benefits.

Changes are made as to time for appeal and terminology in order to conform the code provisions to the Federal Rules of Appellate Procedure. The code provision for appealing from Tax Court decisions within 3 months after entry of decision, is changed to 90 days. In order to resolve a number of cases in which appellate jurisdiction is being challenged because the petition for review was filed within 3 months but after 90 days, the amendments provide that a petition is timely filed if it is filed within either time period. This applies in cases where the Tax Court decision is entered before the thirtieth day after the bill's enactment. Thereafter, the 90-day rule is to apply.

The amendments specifically provide that the United States Tax Court established by the bill is a continuation of the existing Tax Court of the United States and the bill is to have no effect upon existing litigation, jurisdiction, etc.

Effective dates.—The provisions dealing with the treatment of small tax cases will become effective one year after the bill's enactment. This is done so that the Court and the Internal Revenue Service will have sufficient time to examine into any new procedures and rules that would be appropriate in dealing with such cases. The other provisions of this section become effective on the date of enactment, except that in the case of judges who are now members of the Court, special rules are provided with regard to their status for retirement purposes, but their current terms of office will expire on the dates they would have expired under present law. The changes conforming to the Federal Rules of Appellate Procedure take effect 30 days after enactment.

Revenue effect.—These provisions are expected to have no revenue effect.

DD. HOUSE PROVISIONS DELETED BY COMMITTEE

1. Limitation on Deduction of Interest (sec. 221 of the House bill)

Present law.—Present law allows individual taxpayers an itemized deduction, without limitation, for all interest paid or accrued during the taxable year.

Reasons for deleting House provision.—The House was concerned that the present deduction for interest allows taxpayers to voluntarily incur a substantial interest expense on funds borrowed to purchase growth stocks (or other investments initially producing low income) and to then use the interest deduction to shelter other income from taxation. Where a taxpayer's investment produces little or no current income, the effect of allowing a current deduction for interest on funds used to make the investment is to allow the interest deduction to offset other ordinary income while the income finally obtained from the investments results in capital gains.

For the above reasons, the House bill would have limited the deduction allowed individuals for interest on funds borrowed for investment purposes (but not interest incurred in a trade or business). Under the provision, a taxpayer's deduction for investment interest would have been limited to the amount of his net investment income (dividends, interest, rents, etc.), plus the amount of his long-term capital gains, plus $25,000.

Under the House bill investment interest in excess of $25,000 would first have been offset against net investment income and then would have been offset against long-term capital gain income (before the 50 percent capital gains deduction). A carryover of disallowed interest would have been allowed so that the disallowed interest could have been used to offset investment income (and capital gains) in subsequent years.

The Treasury Department, however, recommended to the committee that the interest limitation be deleted pending further study. It noted that there is an abuse in this area which results from the possibility of acquiring growth property with borrowed funds, deducting the interest expense against ordinary income, and then treating the ultimate gain on the property as a capital gain. It believes, however, that the House provision did not correct many of the problems in this area. Particularly it expressed concern that the provision would affect the taxpayer who has only earned income more severely than an individual who also has investment income.

In view of this, the committee believes this provision of the House bill should be deleted pending further study of this problem. However, investment interest expense in excess of investment income is an item included in the base for the minimum tax on preference income which is provided in the committee amendments.

2. Other Deferred Compensation (sec. 321 of the House bill)

Present law.—In 1960, the Internal Revenue Service issued a comprehensive ruling (Revenue Ruling 60-31) describing various types of deferred compensation arrangements in which tax deferral was available. In general, the basis for the ruling was that the employee did not have the right to receive the compensation immediately and, therefore, the employee had not constructively received the additional compensation. This treatment is available only with respect to unfunded arrangements. In the case of funded arrangements, the employee is taxed currently on the contribution (if his rights are nonforfeitable) even though he may not immediately receive the compensation. The following example is typical of the tax deferral arrangements covered by the Revenue Ruling: The employer and the employee enter into a 5 year employment contract which provides for a specified amount of current compensation and an additional specified amount of nonforfeitable deferred compensation. The deferred compensation is credited to a reserve account on the company's books and is accumulated and paid out in equal annual installments in the first 10 years after the employee's retirement.

Reasons for deleting House provision.—The House was concerned with the present treatment of deferred compensation under the Internal Revenue Service ruling because it provides employers and employees with the opportunity of shifting income from high tax years during employment to retirement years when the marginal tax bracket can be expected to be substantially lower. This tax treatment is not available when the amount to be deferred is placed in trust but is available when the amount is accumulated on the books of the employer corporation and represents a promise to pay on its behalf. As a result, key employees who are in a position to enter into deferred compensation arrangements with employers can avoid the graduation in the present tax structure intended to be generally applicable.

To deal with this problem, the House bill would have continued to tax the deferred compensation in the situations described above when it was received, but to the extent the deferred compensation exceeded $10,000 a year, it would have taxed the income at the rates which would have been applicable had the income been received when earned. This would have been accomplished by determining the tax which would have applied had the income been received over the employee's entire period of service with the employer, or over the period to which the deferred compensation is properly attributable. An alternative method would have based the tax on the average compensation for the three highest years during the last 10 years of the earning period.

The Treasury Department recommended that this provision be deleted from the bill. The Treasury indicated that further analysis was necessary to determine whether the proposed solution was consistent with the cash basis of accounting and whether alternative solutions were available. The Treasury also indicated there are a number of problems in the practical operation of the provision which it believed had not been solved satisfactorily. Among these are the scope of the term "deferred compensation," and the determination of the year in which deferred compensation is deemed to have been earned. The Treasury Department has undertaken a comprehensive study of both qualified and nonqualified employee benefit plans, and it intends, as part of this study, to develop recommendations dealing with the tax consequences of all deferred compensation arrangements.

The committee agrees with the concern of the House in this regard, but believes that the administrative difficulties associated with the House provision make further study desirable. The committee has, therefore, deleted this provision from the bill pending further study by the Treasury Department.

3. Foreign Tax Credit (secs. 431 and 432 of the House bill)

Present law.—Under present law a U.S. taxpayer is allowed a foreign tax credit against his U.S. tax liability on foreign income. Generally, the amount of the credit is limited to the amount of U.S. tax on the foreign income.

There are two alternative formulations of the limitation on the foreign tax credit: the "per country" limitation and the "overall" limitation. Under the per country limitation, foreign taxes and income are considered on a country-by-country basis. Under the overall limitation, on the other hand, all foreign taxes and foreign income are aggregated. Thus, under this latter limitation, foreign taxes in one country, in effect, can be averaged with lower foreign taxes in another foreign country.

Reasons for deleting House provision.—The House was concerned with the way, the per country limitation operates where losses occur in one or more foreign countries and income is earned domestically.

Another problem with which the House was concerned is the relationship of royalty payments to tax payments where the taxing authority in a foreign country is also the owner of mineral rights in that country.

The House bill would have provided that a taxpayer who uses the per country limitation, and who reduces his U.S. tax on U.S. income by reason of a loss from a foreign country, is to have the resulting tax benefit recaptured when income is subsequently derived from the foreign country involved. The House bill also would have provided a separate foreign tax credit limitation in the case of foreign mineral income so that excess credits from this source could not be used to reduce U.S. tax on other foreign income. In other words, the foreign tax credit allowed on mineral income from a foreign country would have been limited to the amount of U.S. tax on that income. Excess credits could have been carried over under normal foreign tax credit carryover rules and credited against U.S. tax in other years on the foreign mineral income.

The magnitude of the problems which were of concern to the House is not clear. Before taking action in this area, the committee believes that additional and more comprehensive information is needed. Without this information it is difficult to devise an appropriate solution to those problems which are found to exist. The approach of the House bill would have produced inequitable treatment in some cases. In addition, the House approach did not take adequate account of the varieties in tax systems employed by foreign countries in taxing operations conducted by U.S. taxpayers in their country.

The Treasury Department has informed the committee that it is studying the various aspects of the U.S. tax law relating to the taxation of foreign income and is going to make comprehensive recommendations on this subject to Congress in the reasonably near future. In view of this and the considerations discussed above, the committee has deleted the two additional limitations on the foreign tax credit which the House bill would have provided.

4. Cooperatives: Payment of Patronage Allocations (sec. 531 of the House bill)

Present law.—In determining taxable income under present law, cooperatives are permitted a deduction (or exclusion) for patronage dividends paid in money or in qualified patronage allocations. They also are permitted a deduction (or exclusion) for qualified per-unit retain certificates (that is, certificates issued to patrons to reflect the retention by the cooperative of a portion of the proceeds of the marketing of products for the patrons).

A patronage allocation, or per-unit retain certificate, is qualified—and, therefore, allowed as a deduction or exclusion to the cooperative—only if the patron consents to take it into account currently as income (or as a reduction in price in the case of purchases from the cooperative). Thus, in general, a cooperative is not taxed on patronage allocations or per-unit retains only if they are taxable to patrons. In the case of qualified patronage dividends, present law requires that 20 percent must be paid in money so that the patron will have all or part of the money to pay the tax.

Reasons for deleting the House provision.—The House bill would have made two basic changes in the tax treatment of cooperatives. First, it would have increased from 20 to 50 percent the percentage of patronage allocations that must be paid out currently in cash or by qualified check. The additional 30 percent could be paid with respect to current allocations or in redemption of prior allocations. Second, it would have required cooperatives to revolve out patronage dividends and per unit retains within 15 years from the time they are issued.

The Assistant Secretary of the Treasury for Tax Policy in his testimony before the committee recommended that the first of these two changes be eliminated. He indicated that the provision is complex and would create serious administrative problems. Information submitted to the committee indicated that the second requirement would impair the ability of cooperatives to obtain borrowed capital, because if the amounts allocable to patrons must be paid out within 15 years after they are allocated, the cooperative would have no equity base to support its borrowing.

The committee believes that the provisions of the House bill would have a detrimental impact on the financial structure of cooperatives, particularly on small or newly organized cooperatives. It has, therefore, decided to delete from the bill the provisions relating to cooperatives.

The committee, however, is concerned over the extent to which cooperatives are increasingly engaging in activities such as heavy manufacturing which are unrelated to the purpose for which the special tax treatment of cooperatives was originally granted. It has, therefore, asked the Treasury Department, the committee staff, and the staff of the Joint Committee on Internal Revenue Taxation to conduct a study of these activities and to formulate a proposal by which the special tax treatment of cooperatives can be withdrawn with respect to these unrelated activities.

5. Maximum Tax on Earned Income (sec. 802 of the House bill)

Present law.—Under present law, the individual income tax rates reach a maximum of 70 percent for taxable income in excess of $100,000 for single persons and $200,000 for joint returns. The 70 percent rate is applicable to all taxable income other than capital gains subject to the alternative rate of 25 percent.

Reasons for deleting House provision.—The House believed that the present tax rates with a maximum of 70 percent (without regard to the surcharge) particularly in the case of earned income tend to discourage effort and encourage tax avoidance devices. As a result, the House bill would have provided that the maximum marginal tax rate applicable to an individual's earned income was not to exceed 50 percent (although the rates on other income were still to reach 65 percent in 1972 and later years).

The committee questioned whether it was appropriate to single out earned income for preferential exemption from the top marginal tax rates while still imposing a much higher tax on income from other sources, particularly when a given taxpayer might benefit from the 50 percent limit on earned income and still make use of tax preferences to minimize his tax on other income. Questions can also be raised as to whether a reduction in the marginal rate on earned income by so substantial an amount as provided by the House bill is consistent with the progressive rate structure for individuals.

For the reasons indicated above, the committee deleted this provision of the House bill. It has, however, provided uniform rate reductions for all tax brackets in a manner which is in keeping with the progressive rate system.

V. CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).

VI. INDIVIDUAL VIEWS OF SENATOR ALBERT GORE

The Tax Reform Act of 1969 as reported by the Finance Committee is a significant step in achieving greater equity in our tax system. It embodies two principles: Tax reform and tax relief.

Tax reform should insure that those who are paying too little of the total tax budren relative to their income, because of special tax preferences, will bear a fairer share of the total tax burden.

Tax reduction should provide tax relief for those who are paying too much in taxes relative to their income and need.

In evaluating the provisions of the bill—both tax reform and tax relief—an overriding standard must be applied. This standard is embodied in the Cordell Hull principle of progressivity—taxation based on ability to pay—that was at the heart of the successful move to adopt a Federal income tax as a national policy.

I. Tax Relief

To achieve these ends of social justice, the personal exemption of income from Federal income tax must be raised from the present unrealistic, unfair $600 to $1,000. Such an amendment will be proposed.

Fairness and equity require tax reductions for those who are now paying too much in taxes—primarily the low- and middle-income taxpayers. This tax relief should be granted in a simple, easily understood fashion and pursuant to the fundamental basis of a fair tax system—a progressive tax structure.

The rate changes contained in the House bill, approved by an 8-to-8 vote by the Finance Committee and endorsed by the Administration, are actually regressive. They would undo much of the reform so laboriously achieved in the remainder of the bill. These rate changes, providing a 1 percentage point reduction in the bottom income brackets and up to an 8 percentage point reduction in high brackets, should not be adopted in any event.

The fairest and simplest means of providing tax relief is to increase the personal exemption to $1,000 per person. In addition, the proposed amendment provides for a low-income allowance for each taxpayer, as the committee bill does, except that the allowance here proposed is for $1,000 while the committee bill provides for $1,100. This amendment will be offered as a substitute for all the personal tax reduction provisions in the bill (except those that provide a new rate schedule for single persons).

For a family of four, the present $600 exemption provides a lower amount of tax-free income for the necessities of life than was available to a family of four in 1940. Yet the cost of living has risen more than 2½ times since that date—from a Consumer Price Index of 48.8 to today's 128. No one, then, can seriously question the inadequacy of the present $600 exemption. Who can live on $50 per month?

Increasing the personal exemption to $1,000 per person would be a significant step toward restoring a reasonable relationship between the personal exemption and the increasing cost of living. It is also the most effective and fairest means of achieving tax relief.

A basic choice must be made by the Senate between two methods of individual tax reduction: (1) tax reduction through an increase in the personal exemption which will give the most tax relief where it is needed—the low- and middle-income taxpayer with the largest number of dependents, or (2) changes in rate schedules which provide a disproportionate and, in my view, unfairly large tax reduction for those in the high-income brackets.

Because of the fiscal position of our Government, it is proposed that the personal exemption be increased by $100 in 1970; $200 in 1971; $300 in 1972; and $400 in 1973; to a total of $1,000. The low-income allowance will also be phased in over the same period by the proposed amendment.

From support indicated, it is believed that the Senate may adopt this amendment to increase the personal exemption to $1,000, phased in at a $100 increase per year for the next 4 years, comparable to the phased in tax relief of the committee bill. However, should the Senate reject this amendment, an amendment providing for an increase of the personal exemption to $900, again phased at a $100 increase per year, will be offered; then $800, should that fail. This procedure would assure the Senate of a clear-cut choice between an increase in the personal exemption on the one hand, and the rate changes of the committee bill on the other.

Comparison to committee bill.—The proposal to increase the personal exemption to $1,000 and provide a $1,000 low-income allowance is significantly more effective for those in poverty and those struggling to raise themselves out of poverty than is the committee bill provision for a $1,100 low-income allowance. The following table compares the amount of tax-exempt income that the two proposals provide to various size families.

TABLE 1.—COMPARISON OF INCREASE IN PERSONAL EXEMPTION PROPOSAL TO H.R. 13270 LOW-INCOME ALLOWANCE

Number in family	Amount of nontaxable income allowed under present law	Amount of nontaxable income under H.R. 13270	Amount of nontaxable income under proposal			
			1970	1971	1972	1973
1	$900	$1,700	$1,700	$1,800	$1,900	$2,000
2	1,600	2,300	2,400	2,600	2,800	3,000
3	2,300	2,900	3,100	3,400	3,700	4,000
4	3,000	3,500	3,800	4,200	4,600	5,000
5	3,700	4,100	4,500	5,000	5,500	6,000
6	4,400	4,700	5,200	5,800	6,400	7,000
7	5,100	5,300	5,900	6,600	7,300	8,000
8	5,800	5,900	6,600	7,400	8,200	9,000

In addition, the increase in the personal exemption, coupled with the new low-income allowance-standard deduction, provides more effective relief for low- and middle-income taxpayers than does the complex mix of provisions for tax reduction in the committee bill.

TABLE 2.—COMPARISON OF INCREASE IN PERSONAL EXEMPTION PROPOSAL AND H.R. 13270 TAX ON FAMILY OF 4

[Assumes nonbusiness expenses equal 20 percent of income]

AGI	Present law	H.R. 13270 [1]	Proposal [1]
$3,000	0	0	0
$3,500	$56	0	0
$4,000	112	$65	0
$5,000	230	200	0
$7,500	552	516	$290
$10,000	924	868	620
$12,500	1,304	1,228	1,000
$15,000	1,732	1,636	1,380
$17,500	2,172	2,056	1,820
$20,000	2,660	2,508	2,260
$25,000	3,708	3,492	3,260
$50,000	11,060	10,452	10,340
$100,000	31,948	29,692	31,020

[1] Provisions as effective for taxable years beginning in 1973.

TABLE 3.—COMPARISON OF INCREASE IN PERSONAL EXEMPTION PROPOSAL AND H.R. 13270 TAX ON MARRIED COUPLE WITH NO DEPENDENTS

[Assumes nonbusiness expenses equal 20 percent of income]

AGI	Present law	H.R. 13270 [1]	Proposal
$2,300	$87	0	0
$3,000	170	$91	0
$4,000	290	228	$140
$5,000	418	375	290
$7,500	772	724	620
$10,000	1,152	1,084	1,000
$12,500	1,556	1,468	1,380
$15,000	1,996	1,888	1,820
$17,500	2,460	2,324	2,260
$20,000	3,484	2,784	2,660
$25,000	4,044	3,816	3,820
$50,000	11,600	10,956	11,240
$100,000	32,644	30,316	32,180

[1] Provisions as effective for taxable years beginning in 1973.

TABLE 4.—COMPARISON OF INCREASE IN PERSONAL EXEMPTION PROPOSAL AND H.R. 13270 TAX ON SINGLE PERSON

[Assumes nonbusiness deductions equal 20 percent of income]

AGI	Present law	H.R. 13270 [1]	Proposal
$900	0	0	0
$1,700	$109	0	0
$3,000	276	$180	$135
$4,000	424	344	290
$5,000	576	524	470
$7,500	998	930	850
$10,000	1,480	1,358	1,270
$12,500	2,022	1,826	1,730
$15,000	2,638	2,334	2,230
$17,500	3,334	2,882	2,770
$20,000	4,096	3,470	3,350
$25,000	5,800	4,766	4,630
$50,000	16,322	13,218	13,010
$100,000	41,394	36,290	36,050

[1] Provisions as effective for taxable years beginning in 1973.

Some argue that increasing the personal exemption is not desirable because a person in the 70-percent bracket gets relatively more benefit out of the exemption than does a person in a lower tax bracket. This, however, is just another way of describing the effect of any personal exemption. That is, a personal exemption presupposes that every person is entitled to a certain amount of income on which a zero rate of tax is imposed. Further, the facts show that an increase in the personal exemption centers tax relief on the low- and middle-income taxpayer and provides very little in the way of tax relief to upper-bracket taxpayers. Thus, over 80 percent of the tax relief from increasing the personal exemption will go to wage earners with less than $15,000 per year income, of which 30 percent goes to persons with less than $7,000 per year income and 50 percent to persons making between $7,000 and $15,000 per year. Only a very small portion of the tax reduction goes to persons in tax brackets above $50,000—about 2.5 percent. Put another way, less than 20 percent of the relief from this proposal goes to persons with incomes over $15,000 compared to over 33 percent under the Finance Committee bill. (See app. A.)

The simplicity achieved by increasing the personal exemption more than offsets the theoretical problem that opponents raise. This is the form of relief that will be most easily understood and will provide the most benefit to the average taxpayer. Almost 11.5 million taxpayers are removed from the tax rolls under this proposal compared to only 5.5 million under the committee bill.

Further the proposal to increase the personal exemption is fairer and more progressive than the increase in the standard deduction and the rate reductions provided in the committee bill.

The House bill approved by the committee contains an increase in the standard deduction from 10 percent of adjusted gross income or $1,000, to 15 percent or $2,000. The increase is effected over a 3-year period. This step is intended to provide tax relief and tax simplification primarily for taxpayers in the $7,000 to $15,000 income range.

The proposal in the committee bill to increase the standard deduction achieves tax relief and simplicity for some taxpayers but only at a considerable cost in tax equity. Thus the increase in the standard deduction will reduce taxes for the family living in an apartment, but may not provide any tax relief at all for the family with the same income that is buying a home. Similarly, the provision has widely disparate and unfair results as between taxpayers who live in States imposing a high-income tax and those living in States with low-income taxes.

An example will illustrate the arbitrary and potentially inequitable result of increasing the standard deduction. Assume that family A and family B (each with four members) reside in State X and State Y respectively. Each has $20,000 of wage income. Family A pays $1,000 per year in income taxes to State X; family B pays $2,500 in income taxes to State Y. The State income taxes are the only personal deductions for each family. Under present law, family A will pay $3,428 in Federal taxes and family B will pay $3,035. Under the bill, however, in 1972 family A will have a tax reduction (including rate changes) of $560. Family B will, however, have a tax reduction of only $282, because the increase in the standard deduction is of no benefit.

There is no reason of tax equity which would require such different results. Indeed the bill produces a greater tax reduction for the family that already has the smaller combined State and Federal tax burden.

An increase in the standard deduction, then, would achieve tax reduction for some taxpayers selected on a totally arbitrary basis. It does achieve some simplification—but at too great a cost in tax equity.

On the other hand, an increase in the personal exemption treats the two families in the above example even-handedly. It provides a Federal tax reduction in an approximately equal amount for each. It is thus apparent that the increase in the personal exemption achieves the simplicity sought and avoids the inequities created by the capricious application of the standard deduction increase.

The committee bill also provides for rate reductions that are scheduled to be fully effective in 1972. These rate reductions as already pointed out, if adopted, would be a further step in making our tax system more regressive instead of more progressive.

The top bracket under present law is 70 percent for income over $100,000. Under the bill, however, the top marginal rate is reduced to 65 percent of the amount of income over $200,000. Not only is the top bracket lowered by 5 percentage points, but the brackets are also changed so that, for example, income between $100,000 and $200,000 receives a rate reduction ranging from 6 to 8 percentage points. Such a step is unjustified whether or not the personal exemption is increased. Coupled with the 1964 cut in the top rate from 91 to 70 percent, progressivity in the upper brackets has been sharply curtailed.

Contrast the treatment of the high-income person with that accorded the low-income taxpayer. The bottom bracket was reduced by 1 percentage point from 14 to 13 percent and this marginal rate doubles between taxable income of $500 and taxable income of $10,000. On the other hand, between $100,000 and $200,000 of taxable income, the marginal rate increases by only 5 percentage points.

The rate reductions provide $641 million of tax relief to 95,000 persons with incomes over $100,000. This is more than the total amount of tax relief provided to 30 million taxpayers with incomes under $7,000 per year through rate reductions.

This rate reduction, it is clear, benefits the wealthy far more than it does the middle-income taxpayers. These tax benefits for the wealthy coupled with removal of poverty level persons from the tax rolls place the middle income taxpayer in a vise and he is being squeezed from both ends of the economic scale.

Our tax system has become steadily less progressive since 1964. The rate reduction provisions of the bill continue that process. There should be no mistake. A reduction in progressivity is just another way of increasing the tax burden for the average taxpayer on whom the major burden of our tax system already falls.

Finally, opponents of this proposal argue that our current revenue needs will not permit an increase in the personal exemption to the level of $1,000. This is not true. The following comparison shows that for 1970 and 1971 (the only years for which reliable estimates can be made), the personal exemption proposal is well within the bounds of fiscal responsibility as compared to the committee bill.

TABLE 5.—TAX REFORM AND TAX RELIEF (CALENDAR YEAR LIABILITY)

[In billions]

	1970	1971
Additional revenue from Finance Committee tax reforms	$3.9	$4.645
Revenue reduction by proposed increase in personal exemptions	4.0	7.7

If only a few of the following possible tax reforms were adopted by the Senate, the program of tax reform and tax relief could be more than balanced for the immediate future:

Reform	*Increase in revenue*
Removal of new loopholes from bill	$720,000,000
Repeal of percentage depletion and capitalization of intangible drilling costs	1,445,000,000
Restoration of House bill on foreign tax credit	65,000,000
Restoration of House bill on capital gains	180,000,000
Restoration of House bill on financial institutions	235,000,000
Repeal of accelerated depreciation for real estate (except low- and middle-income housing) and capitalization of construction period interest costs, taxes, etc.	1,200,000,000
Minimum tax and allocation of deductions for individuals (except tax-exempt interest)	1,300,000,000
Total	5,145,000,000

When coupled with the $6,605,000,000 of long-term revenue gain from Finance Committee approved reforms, the total revenue gain from tax reform could thus reasonably be expected to reach $11,-750,000,000.

Moreover, large reductions in expenditures are anticipated from military cutbacks.

II. Tax Reforms for Possible Consideration

NEW TAX LOOPHOLES

In a tax bill which devotes hundreds of pages to an effort to achieve tax reform, it is distressing that some taxpayers will get new loopholes created for them, albeit in the name of tax incentives.

These new loopholes are contained in the three provisions permitting rapid depreciation (or amortization) of expenses for railroad rolling stock and locomotives, pollution control facilities, and rehabilitation of low- and middle-income housing. These provisions will cost the taxpayer $720 million in tax expenditures—$830 million under the House bill—$720 million that ought to be going to low- and middle-income taxpayers in the form of tax relief. It is interesting to note the persons and corporations that will benefit from these provisions:

Those railroads that are presently in a profitable position;

The factories that have been polluting our air and water for the past 100 years;

The slumlords, some of whom have kept low-income people in conditions of housing misery;

Syndicates created to invest in the tax losses generated by these new deductions—a big, new loophole.

There is no reason why any of these groups should have a claim to three-fourths of a billion dollars ahead of the average taxpayer, particularly the hard-pressed taxpayer with dependents.

Information furnished the Finance Committee indicated that the dimensions of the benefits accorded by these provisions can be illustrated by recasting them in other forms. The House bill granted a 5-year rapid writeoff for pollution control facilities. Many of these facilities have a useful life of as long as 50 years. A 5-year writeoff for such a facility is the same as granting a 20-percent investment credit to the corporation for that facility. This action is especially unjustified when we are in the same bill repealing the 7-percent investment credit. Fortunately the Finance Committee substantially revised the House provision, but the fact remains that there is no justification for creating this new loophole. The recent Senate action in approving a $1 billion pollution control program renders this tax loophole provision superfluous.

Similarly it is instructive to recast the rapid writeoff benefit being accorded slumlords to rehabilitate low-income housing. The bill rule provides 70 percent taxpayers with the equivalent of a 19-percent investment credit with respect to expenditures for items that have a 20-year useful life.

It is also possible to view this new real estate tax loophole as a Federal subsidy to reduce the taxpayer's costs incurred to finance the project. In the case of a 70-percent bracket taxpayer who makes expenditures with a 20-year useful life, the bill rule has the effect of lowering his interest expense from 8 to 3 percent. The discriminatory nature of the rule is made apparent in the fact that a 20-percent bracket taxpayer would have his 8-percent interest rate reduced to only 7 percent. Now, one cannot reasonably imagine HUD coming to Congress and proposing a housing rehabilitation program under which it would loan money to the wealthy at 3 percent, but would charge middle income taxpayers 7 percent. Congress would reject such a proposal out of hand. Yet this is precisely the system which Congress is endorsing in this new real estate loophole.

For railroads, the new "incentives" provide an investment credit equal to almost 5 percent. Why railroads should get a continuing investment credit when it is being repealed for other industries has never been explained.

A further difficulty of each of these provisions is that wealthy individuals are provided more opportunities to engage in tax profiteering. We can expect the formation of syndicates of high-bracket taxpayers who will ostensibly be investing in these various activities. Leasing syndicates were formed under present rules to "buy" and "lease" airplanes to our major airlines. The only economic significance of these transactions was the marketing of the tax advantages of the investment credit and accelerated depreciation to wealthy taxpayers so that they could reduce their taxes. Now the same kind of gimmickery will be engaged in with railroad boxcars and locomotives, housing, and pollution facilities.

The creation of these new loopholes in a bill for tax reform is an insult to the American taxpayer.

If these moneys are to be spent for railroads, pollution control, and housing, then the money should be allocated through the regular appropriations processes so that informed judgments can be made by those with expertise in these respective areas as to the priorities that should be established for the expenditure of these funds. They cannot be justified in terms of tax policy since they are contrary to proper accounting rules. Nor can they be justified as a rational expenditure policy since there is no evidence that these tax expenditures are consistent with our national priorities.

These new loopholes should be stricken from the law.

Blueprint for reform.—There is no reason any longer to bestow percentage depletion on any minerals. If percentage depletion were disallowed in its entirety, additional revenues of approximately $1.5 billion would be produced. Placed in the perspective of the individual taxpayer, this revenue would permit an additional exemption of $50 per person for every man, woman, and child in the United States. Percentage depletion is too high a cost for the average taxpayer to bear to subsidize an industry that can full well stand on its own economic feet.

A further advantage is accorded the oil and gas industry in the provision permitting immediate deduction of intangible drilling and development expenses. This special relief, which is not granted to other enterprises, costs an additional $750 million per year.

What does the American taxpayer get for this annual expenditure of $2.25 billion ($1.6 billion if the present system had never been in effect)? The oil companies argue that this is the incentive required to find new reserves. But this is clearly false. The 1968 Treasury studies and the CONSAD report reveal that for this expenditure only $150 million of new reserves of oil are discovered that would not have been found in any event.

This is an enormous waste of Federal funds. If Congress were annually to appropriate to the oil companies $1.6 billion just to get $150 million of new reserves, the public would be outraged, and properly so. But this is precisely what we are doing each year through the tax system. Further, how can allowing percentage depletion to a landowner possibly promote greater discovery effort? The oil companies cannot therefore justify percentage depletion on the basis that it is an incentive to provide new sources of oil.

Nor can the special tax privileges be justified on the basis of risk. A perusal of the annual reports of the oil companies themselves shows that most wells sunk by the companies are development wells—not exploratory wells. And the companies' own figures show that 80 to 90 percent of the development wells are producers. The wage earner takes more risk in driving to work in the morning than does an oil company in drilling a development well.

The oil companies also argue that permitting them to recover their costs tens and even hundreds of times over keeps the price of gasoline lower. The 1968 Treasury study estimated that repeal of percentage depletion might produce a maximum increase of 2½ cents per gallon for gasoline. Even if this were accepted as a fact, is it not appropriate for the consumer of gasoline to pay the proper price, rather than having part of his gasoline costs paid for by every taxpayer? In other words, why should nondrivers and bus and subway commuters pay higher income taxes so that automobile drivers and truck companies can buy gasoline cheaper? Similarly, if one accepts the position that natural gas prices may rise for the consumer, why should every household using electricity pay higher income taxes so that others may have lower gas prices?

Further, if the oil companies are really so concerned about the consumer having to pay higher prices, there is a solution close at hand. The import quotas can be modified so that more oil and gas can be imported, thereby keeping prices to the consumer down.

It must be recognized that the right to write off immediately intangible drilling and development expenses is inconsistent with basic income tax precepts. These expenses represent the cost of acquiring a capital asset; as such, they should be capitalized and recovered through amortization. A builder is required to capitalize these costs and recover them through depreciation. The same rules should apply to intangible expenses deducted prior to sale or transfer of the mineral property.

What is required is to construct a rational mineral policy for our country. To accomplish this goal the present inefficient system of tax incentives must be discarded. The following system may serve as a blueprint for reform:

1. Repeal of percentage depletion (cost depletion would be retained);
2. Require capitalization of all exploration, drilling and development costs, with those costs to be recovered through amortization over the life of the property;
3. The creation of a simple system of direct subsidies to encourage exploration for *new* mineral resources, *if* these are needed and are consistent with national priorities.

Bill provisions

(1) *Percentage depletion rates.*—The case against any percentage depletion allowance has now been so convincingly made that it is disappointing to see the House bill reducing percentage depletion by only 25 percent for all minerals. The actions of the Finance Committee in revising the percentage depletion allowance back to 23 percent for oil and gas, restoring present rates for all other minerals, and providing an increase in percentage depletion for copper, gold, silver, and oil shale are completely unjustified.

A measure of the inadequacy of the provisions approved by the committee with respect to percentage depletion is vividly demonstrated by the fact that they will produce only $155 million additional revenue compared to a $400 million revenue gain under the House provisions.

The deviation from the ideal permitted by the committee action is too great. At the very least, the Senate should restore the House bill. Indeed there is no real reason why Congress should not now adopt a schedule for total elimination of the depletion allowance.

(2) *Increases in net income limitations.*—Present law provides that the percentage depletion deduction shall not exceed 50 percent of a taxpayer's taxable income from mineral property.

The Finance Committee very unwisely raised this limitation in the case of certain oil and gas producers and for copper, gold, and silver.

In the case of oil and gas, the percentage was raised from 50 to 65 percent for producers with less than $3 million of gross income from oil and gas. The effect of this change will be to grant some taxpayers more percentage depletion than they would have received under present rules. This selective hidden increase in percentage depletion at a time when the public is led to believe that depletion rates are being lowered is completely without justification.

An example will illustrate the impact of the committee rule. Assume an oil company has $1 million of gross income from oil which cost $600,000 to produce. Under present law, the 50-percent limitation would permit the taxpayer to deduct only $200,000. Under the committee provision, however, this 50-percent limit would be raised to 65 percent. The taxpayer would thus get a deduction of $260,000. Thus, the taxpayer gets a depletion allowance 30 percent higher than if present law had been left unchanged. Such a result cannot be justified.

The Finance Committee made a similar error increasing the 50-percent limit in the case of copper, gold, and silver to 70 percent. This has the effect of increasing the present percentage depletion rate for certain producers of these minerals by 40 percent. The increase in the limit for oil and gas was justified as an aid to the so-called small producer. But there can plainly be no such justification in the case of copper, gold, and silver. Virtually all U.S. copper production is in the hands of four industrial giants. What possible justification can there be for giving these companies an increase in percentage depletion? The House bill excepted these minerals from the general cut in depletion rates, and that treatment was more than generous.

The action of the committee in raising the 50-percent limit is especially incongruous in light of its action in correcting the tax treatment of production payments. Production payments have been used as a means of avoiding the 50-percent limit. The committee closed this loophole by requiring that production payments be treated as loans. However, to close this loophole, and then increase the limit on depletion is completely inconsistent. This action largely undid for these select taxpayers what had been accomplished by reforming the production payment rules.

The Senate should strike these special provisions from the bill.

(3) *Additional depletion.*—Two other actions taken by the committee are inconsistent with the announced purpose of reducing percentage depletion. One provision grants percentage depletion for certain minerals extracted from the Great Salt Lake. The other includes a manufacturing process in the percentage depletion base for oil shale. These provisions should be stricken.

It has been a fundamental rule that percentage depletion is not available if the mineral is obtained from an "inexhaustible source." In such a case the mineral is not being depleted. The Great Salt Lake is such a source. The Internal Revenue Service has investigated this matter in great depth and has concluded that no depletion should therefore be allowed for minerals extracted from the Great Salt Lake.

The action of the Finance Committee overturns this basic rule. This is an undesirable precedent which has no justifiable basis in tax law and provides a depletion allowance when none has heretofore been granted.

The committee also followed the House bill in allowing a manufacturing process to be included in the percentage depletion base in the case of oil shale. The Treasury has estimated that this action has the effect of doubling the percentage depletion base for oil shale.

The revenue cost of this measure is impossible to predict, but it can be predicted that every other mineral producer will soon be on the steps of Congress demanding that its manufacturing processes be included in the depletion base. The revenue cost then could amount to many millions of dollars.

The Treasury has opposed this special privilege for oil shale. The Senate should support the Treasury position and strike the provision from the bill.

FOREIGN TAX CREDIT

The proper mode of taxation of U.S. corporations doing business abroad poses a difficult and complex problem. The Treasury has advised that it is engaged in a major study of the provisions of the Code dealing with this issue and will make recommendations for a comprehensive revision of U.S. tax treatment of foreign operations by our businesses.

In addition, there has been introduced a sweeping revision of subpart F (S. 2645) to end the unjustified deferral of tax on income of U.S.-controlled foreign subsidiaries. This proposal should be included in any broad study.

Bill provisions

Pending the completion of this much-needed study, however, there are two defects that should now be corrected to insure that the foreign tax credit as presently constituted operates effectively and fairly:

1. The creation of excess foreign tax credits by virtue of foreign treatment of loss carryovers.

2. The creation of excess foreign tax credits from what are essentially royalties paid to a foreign country by U.S. oil companies.

The House bill includes two provisions that deal with these problems. The Finance Committee unfortunately deleted these House provisions. The Senate should act to resolve these issues now.

(1) *Loss carryovers.*—The first problem arises where a U.S. oil company incurs losses in a foreign country during the time it is commencing drilling in that country. These losses are deducted against U.S. income and, thus, a lower U.S. tax is paid. When income is derived from the operations in later years, the foreign country levies its tax on that income without taking into account the losses incurred in prior years. The foreign tax is then claimed by the oil company as a credit against its U.S. tax. What is really happening is that the foreign country is levying a much higher rate of tax on the U.S. company's income (because it is ignoring the loss carryover), and the U.S. tax system is subsidizing this higher tax by virtue of the operation of the foreign tax credit.

An example will illustrate the problem. Assume that oil company A drills in country X. There is a net operating loss of $100 in year 1; there is net income of $100 in years 2 and 3. In each of the 3 years A has U.S. net income of $100. Country X levies a tax at the rate of 50 percent on the net income each year, but does not provide for a loss carryover.

In this example A will pay no taxes in year 1; in years 2 and 3, $50 in taxes will be paid to country X, which will be used as a credit against the U.S. tax of $100, thus leaving a net payment to the United States in each year of $50. This is plainly an incorrect result. Over the 3-year period, company A has realized $300 on its U.S. operations, and should have paid $150 in U.S. tax. Instead the United States received only $100 in taxes. The reason for this reduction in U.S. taxes is that country X has levied a tax of $100 on net income of $100 from the country X operations—in other words, country X has imposed a 100 percent rate of tax on the net income from the operation in that country. The U.S. tax system absorbs the loss occasioned by the improper tax rules of country X.

If both the U.S. tax and the country X tax were working properly, A would have paid $150 in U.S. tax and $50 in foreign tax, rather than $100 in U.S. tax and $100 in foreign tax.

The House bill corrected this problem by providing that, in the example above, the loss must in effect be carried over to subsequent years for purposes of computing the foreign tax credit. This rule would insure that the American tax system is not required to subsidize foreign countries in their oil operations. Further, the present system acts as a positive inducement for foreign countries to continue improper tax systems. The House rule would end that unfortunate effect.

The Treasury has recommended retention of the House rule dealing with carryovers of foreign tax credits, with certain technical modifications. The House rule, as modified, should be adopted by the Senate.

(2) *Foreign mineral income.*—The second problem in the foreign tax credit arises because of the fact that many foreign countries tax mineral income at a rate higher than the United States imposes on mineral income—primarily because the United States allows a deduction for percentage depletion and foreign countries do not. This higher foreign tax rate on mineral income generates excess foreign tax credits which offset U.S. taxes on nonmineral income.

The House attempted to deal with this problem by providing a separate limitation on the foreign tax credit in the case of foreign mineral income. The Treasury has recommended a more straightforward and sounder solution. The Treasury puts the U.S. tax system and the foreign tax system on the same basis for purposes of computing the foreign tax credit on foreign mineral income.

The Finance Committee did not accept either the House or the Treasury solution. The Senate should correct this flagrant loophole which aids only the giant oil companies by adopting the Treasury proposal.

(3) *Earnings and profits computation.*—A third point on which the Finance Committee permitted continued abuse of the foreign tax credit should be noted. The House passed a rule which requires all corporations to compute their earnings and profits on the basis of straight line depreciation. The measure is designed to prevent the payment to stockholders of dividends which are tax-free solely because of accelerated depreciation used for tax purposes.

The House provision also affects the amount of the foreign tax credit. It requires that U.S. corporations receiving dividends from controlled foreign subsidiaries compute the earnings and profits of the subsidiary on the basis of straight line depreciation. This is a proper result since U.S. companies are inflating the foreign tax credit by using accelerated depreciation in computing earnings and profits. The Finance Committee did not adopt this part of the House provision.

The House rule should have been retained. The Finance Committee action favors only a few corporate giants and is wrong both from the standpoint of technical tax policy and tax equity. If U.S. companies doing business only in the U.S. must use straight line depreciation to compute earnings and profits, the same rule should apply to those U.S. companies conducting part of their business through foreign subsidiaries.

The Senate should restore the House rule in this regard.

(4) *Disclosure of information.*—As pointed out above, U.S. oil companies get a major tax break from the improper functioning of the foreign tax credit. The Treasury was asked to provide the revenue dimensions of this abuse, and its estimate of the effectiveness of the House provision. The Treasury advised that this information could not be provided because the oil companies refuse to supply information required by the tax return form. Deputy Assistant Secretary of the Treasury John S. Nolan wrote on September 30, 1969:

> Available information largely precludes our estimating the revenue effects of section 431 for individual oil companies as their tax returns do not reveal the countries in which they are experiencing net loss or the amount of these foreign losses. Although the tax forms and accompanying instructions appear to require U.S. companies using the per country limitation to report foreign losses on a country by country basis, they generally neglect to do so as these losses do not affect the amount of foreign tax credit they can claim. Nor have the oil companies responded to Treasury's request that they voluntarily provide this information, on a confidential basis, for analytic purposes only.

This highhanded treatment of the Internal Revenue requirement by the major oil companies is outrageous, and an affront to every law-abiding taxpayer who dutifully supplies all information called for on his tax return.

The Senate should require oil companies to supply the required data and impose stiff penalties for failure to do so.

CAPITAL GAINS

The House bill did not deal directly with the basic inequities implanted in the Federal income tax system by the preferred treatment accorded capital gains. Even more unfortunately, the Finance Committee retreated from the minimal steps taken in the House bill. The House measures should be restored.

Bill provisions

(1) *Repeal of alternative rate on capital gains.*—The House bill took a minmium step in achieving tax equity by repealing the 25 percent alternative rate on capital gains. This was a highly desirable step, since this tax loophole benefits only the taxpayer who is in a tax bracket above 50-percent. In 1966 only 85,671 taxpayers—about one one-hundredths of 1 percent of all taxpayers—received a tax reduction of $715 million because of the alternative rate. Removal of this privilege would restore some measure of progressivity for taxpayers with above $200,000 of income.

Astonishingly, the Treasury opposed the repeal of this tax relief provision for the wealthy.

Fortunately, the Finance Committee overrode the Treasury in large part, but had to resort to a very complicated system of limitations in order to achieve approximately 90 percent of what the House bill gains by its simple repealer. Nevertheless, the Senate bill still permits some $30 million of unjustified tax reductions to go to less than 10,000 of the wealthier people in this country.

There is no justification for continuing this loophole in any form. The 25-percent alternative tax on capital gains should be repealed outright.

(2) *Holding period of capital assets.*—The House increased from 6 months to 1 year the holding period required in order to obtain long-term capital gain treatment. This was a reasonable and modest step. Yet the Treasury opposed it and the Finance Committee deleted it.

The Senate should restore the House rule.

The factual data available indicate that the 6-month holding period is so short that it is being used by high-bracket speculators to avoid ordinary income rates. For example, gains realized in the seventh month are more than three times those realized in either the third, fourth, or fifth month by persons owning capital assets. Further, persons with incomes over $100,000 realize only 3.1 percent of their first-year gains in the fifth month, while 24.4 percent are realized in the seventh month. However, for under $10,000 income taxpayers the figures are 6 and 12.8 percent respectively.

Thus, it is clear that the 6-month holding period is being used by high-bracket taxpayers to churn their investment twice a year. The furniture dealer who turns his inventory twice a year pays ordinary income rates; there is no reason to give the stock speculator who turns his "inventory" twice a year more preferential tax treatment.

The Senate should restore the 12-month holding period for capital gains.

(3) *Sales of life estates.*—A fundamental rule of the tax laws is that a person cannot convert ordinary income into capital gain by transferring the right to receive the future income.

An exception to this basic rule has been permitted to develop in the case of a person who has the right to income for life from a trust or other property. Present rules permit such a person to sell his income interest and pay capital gains rates. This result is inconsistent with basic tax rules.

The House bill modified the present rule somewhat by providing that the total amount realized on the sale would be treated as capital gain; that is, there would be no reduction in the gain realized for the taxpayer's basis. This provision merely replaces one inconsistent rule with another.

The proper tax treatment of these transactions is to give the taxpayer the benefit of any basis, but to tax all gain as ordinary income under regular rules dealing with transfer of future rights to receive income. The Senate should adopt the proper rule as a substitute for the House provision.

FINANCIAL INSTITUTIONS

Blueprint for reform.—Data now available make it clear that the corporate tax system is not operating equitably with respect to financial institutions. The average effective tax rate paid by all manufacturing corporations is approximately 43 percent. However, the average effective rate for commercial banks is only 23 percent, for savings and loan associations it is only 16 percent, and for mutual savings banks it is only 6 percent.

There are several causes for the fact that financial institutions pay such low effective rates of tax. The chief reason lies in present rules that permit financial institutions to take deductions for additions to bad-debt reserves that are far in excess of actual losses on loans. For commercial banks, present rules permit a deduction for bad debts that is approximately 12 times the actual loss experience on outstanding loans. For mutual savings banks and savings and loan associations, the bad-debt deductions have ranged up to 50 times their actual loss experience.

The second major factor contributing to the low rate of tax of financial institutions is the large amount of tax-exempt income derived from capital gains, State and local bond interest, and the dividends received deduction. Not only is this income tax exempt, but financial institutions are not required to allocate any of the expenses of producing this tax-exempt income to that income. Thus, all expenses of producing income are deducted from taxable income even though tax-exempt income constitutes a significant proportion of the total income of the financial institution.

The proper tax treatment for financial institutions is to allow a deduction for additions to bad-debt reserves computed in the same manner as other corporations, that is, based on actual loss experience. Further, expenses of producing income should be allocated between all categories of taxable and tax-exempt income. In addition, banks should be subject to a minimum tax on tax-exempt income. However, as discussed below, interest on State and local bonds should not be subject to either allocation of deductions or a minimum tax until a viable alternative system for local government financing has been instituted.

Bill provisions

The Finance Committee very drastically reduced the effectiveness of the reforms effected in the House bill. The House bill placed all financial institutions substantially on the same basis as manufacturing corporations with respect to the computation of the deduction for additions to bad-debt reserves. Very generous transition rules were provided, but in the future the House action would have moved financial institutions much closer to a parity of taxation with all other manufacturing corporations. However, the Finance Committee action makes only a nominal gesture toward tax reform. Under the committee bill, commerical banks would still be entitled to a bad-debt deduction nine times larger than they are entitled to under proper tax rules. Even under the House bill commercial banks are moved to an effective rate of only somewhat more than 30 percent, still substantially lower than the effective rate of other corporations.

The committee made similar reductions in the effectiveness of tax revisions dealing with bad-debt reserves of mutual savings banks and savings and loan associations. Under the House bill, the effective rate for these institutions would have been raised to approximately 27 percent. Under the committee action, the effective rate will be 20 percent or less.

The Senate should restore the House rules.

REAL ESTATE

Blueprint for Reform.—Present tax rules grant two types of preferred treatment to real estate: accelerated depreciation which permits artificial "tax losses" to be generated, and capital gains treatment on the sale of the property even though its cost may have been fully recovered through depreciation.

Wealthy individuals use these tax benefits to shelter not only their income from the real estate, but also their income from other sources.

These tax benefits do serious violence to the principle of progressivity. Treasury studies revealed that in 1966, out of a group of 13 wealthy real estate investors, nine reduced their tax liability to zero and two paid less than $25 in tax, due to real estate depreciation deductions. One taxpayer with over $7½ million in income over a 7-year period paid an effective rate of tax on that income of only 11 percent—the same as is paid by a family of four with $10,000 in wage income—because of the special tax benefits accorded real estate investment.

The economic data now available indicate that straight line depreciation is all that is justified for real estate. Deductions for accelerated depreciation constitute an interest-free loan by the Government to wealthy individuals in the amount of the tax that otherwise would have been paid had proper depreciation methods been followed for tax purposes. With interest rates at 9 or 10 percent, this is a very substantial benefit for the Government to bestow on a select few individuals. And with the capital gains rates available on sale, it is a loan that is never repaid.

The result of these tax rules has been a severe distortion of the real estate industry. Persons investing in real estate in many cases have no interest in the investment itself; they are only interested in acquiring "tax losses." A recent example vividly illustrates the point. A large bank has put together a transaction for the construction of a post office to be leased by the Government. The investors to whom the bank is appealing put up only a nominal portion of the total cost. Most of the money for the project is borrowed. During the construction period the "investors" receive current deductions of $4 million out of $4.5 million "construction period" costs. This is because present law permits these construction period costs to be currently deducted rather than capitalized as proper accounting procedures would require. Such is the benefit of these rules that the bank advises potential investors that their after-tax benefits will exceed the original investment by the end of the first year of the lease term.

During the rental period the rents almost exactly equal the interest paid on the loans by the investors. Therefore, there is a minimal cash flow effect. However, the bank proudly advertises that due to tax savings alone—consisting almost entirely of accelerated depreciation—a 70 percent bracket taxpayer can realize a rate of return of 29.33 percent on his cash investment. If his combined State and Federal tax bracket is 75 percent, he will have a 37.29 percent return on his tax savings alone.

This is a totally unjustified system of taxation which makes a mockery of progressivity, and which creates an unhealthy situation for the real estate industry.

The Federal Government is now subsidizing the real estate industry to the extent of $750 million per year through fast depreciation. It has been estimated by experts in the field that only $50 million of this tax subsidy goes for low- and middle-income housing. Even this amount is not used to produce lower rents; it is simply a reward for wealthy individuals. Most of the $750 million goes to subsidize office buildings, shopping centers, and motels. If this $750 million were available to the congressional committees who have the responsibility for formulating our national housing and real estate policies, it is almost impossible to believe that they would vote—or that the voters would tolerate—this kind of priority being established for our housing policy.

It is certainly true that our Nation urgently needs more housing—especially for low- and middle-income families—but our present tax depreciation policy contributes almost nothing to the solution of this pressing national problem.

A national policy for housing, as well as a rational tax policy, should therefore consider the following steps:

1. Tax depreciation for all real estate limited to straight line depreciation. However, 150-percent depreciation should be retained for low- and middle-income housing for a limited period to enable HUD and Congress to formulate a new policy to aid such housing.

2. Interest, taxes, and other capital costs incurred during the construction period should be capitalized and recovered through depreciation.

3. In cooperation with the real estate industry, the Treasury should immediately begin a study to determine if obsolescence of improved real estate can or should be reflected in tax rules.

4. The funds made available to the Federal Government by changes in the tax rules should be made available for appropriation by the committees of Congress responsible for developing our priorities in a national housing policy.

Bill provisions

The Finance Committee bill does take significant steps in the direction of a more rational tax policy for real estate. The reduction of the 200-percent accelerated depreciation method to 150 percent for nonresidential real property is a step in the right direction. So are the recapture provisions of the House bill. The Senate should, however, strengthen the bill in the following respects:

(1) *Accelerated depreciation for housing.*—The House bill and the Finance Committee bill retain the 200-percent accelerated depreciation method for all housing. This means that there is an equal incentive to build luxury housing as to build low- and moderate-income housing. It is clear that anyone who can receive the same tax benefits regardless of whether he builds luxury housing or low-income housing will probably choose to build the luxury housing. Yet as the House report notes, the creation of more luxury housing will do almost nothing to solve the pressing need for low- and moderate-income housing.

If the 200-percent depreciation method is to be retained for any housing, it should be retained only for low- and moderate-income housing. This will provide an incentive to build the housing that is needed most.

(2) *Recapture of accelerated depreciation.*—The Finance Committee weakened the rules of the House bill which in the event of a sale require recapture at ordinary income rates of all accelerated depreci-

ation previously deducted. Complete recapture is the minimum step that should be taken at the present time. There is no justification for granting a Federal subsidy to real estate investors through accelerated depreciation and then granting a further subsidy in the form of capital gains rates after the cost of the property has been fully recovered through depreciation.

The Senate should at least restore the House provisions requiring complete recapture.

PROGRESSIVITY AND EXEMPT INCOME

The preceding comments have measured the provisions of the tax reform bill against the most reliable yardstick—progressivity.

The 1968 Treasury studies produced startling evidence that the wealthy in this country are virtually exempted from the graduated tax system. Much attention has been focused on the 154 taxpayers with adjusted gross incomes in excess of $200,000 who pay no Federal income tax. But this is but the tip of the iceberg.

The list of 154 does not include those who have very high economic incomes but very low adjusted gross incomes because of accelerated depreciation, percentage depletion, or intangible drilling expenses. If a person has only income from tax-exempt bonds, he will not appear on the tax lists at all.

As disturbing as it is that there are taxpayers who pay no Federal income tax, it is equally disturbing to learn that the progressive income tax principle is inoperative for the wealthy in this country. The Treasury study showed that a person with an adjusted gross income of between $50,000 and $100,000 paid an average effective rate of tax of 27.3 percent. Yet a person with over $1 million adjusted gross income paid an effective rate of only 28.4 percent. This is an increase in progressivity of 1.1 percent spread over $900,000 of income.

Under the guise of "tax incentives," the principle of tax progression has been repeatedly eroded. Thus, depletion for oil exploration and accelerated depreciation for real estate have all been paraded before us as necessary to the development of a particular sector of our economy. But we now sadly awaken to the fact that these "incentives" have a Jekyll-Hyde quality, and quickly become "loopholes," undermining the integrity of our tax system and the faith of our people in the fairness of our Government. And in combination, tax loopholes can entirely eliminate the wealthy from the income tax roles—regressivity run rampant.

The result is that we now have a system that is steeply progressive for the lower- and middle-income taxpayer, but is not progressive for the rich. What social justice!

It is apparent, however, that everyone will not agree that we should immediately attain a purely progressive system by eliminating special rules to provide tax exemptions or excessive deductions.

Indeed, some argue with deep personal conviction that these tax incentives are necessary to our national welfare.

In view of this situation, consideration should be given to a supplementary tax system which is itself progressive to insure that all persons will make at least some substantial contribution to the cost of Government. For unless there is such a supplementary system, some persons will be able to combine the special exemptions and deductions in such a way as to totally eliminate themselves from the tax rolls, or to pay such a low rate of tax as to make a mockery of the principle of progressivity.

The House approached this problem by a provision for a limitation on tax preferences (LTP). In addition, the House bill required that individuals allocate their personal deductions between their taxable and tax-exempt income.

The Finance Committee substituted a "minimum tax" for the two House provisions. The committee rule imposes a 5-percent tax on all tax preferred income in excess of $30,000 and is applicable both to individuals and to corporations.

The Finance Committee has taken a proper step insofar as it applies a minimum tax on a flat rate to corporations. The corporate tax structure does not rely on progressivity and the 5-percent minimum tax is a reasonable method of insuring that corporations do not reduce their overall effective rate too low by virtue of combining various types of tax preferred income.

For individuals, however, the Finance Committee approach is not adequate. It imposes the same rate of tax on persons with small amounts of tax preferred income as on the very wealthy who pile up huge amounts of tax-exempt income through a combination of tax schemes.

As a substitute for both the House and Finance Committee versions, consideration should therefore be given to a separate minimum tax schedule for individuals which would impose a graduated tax up to a top level of 35 percent on all the tax preferred income listed by the Finance Committee—but including appreciated property given to charity and artificial farm losses. As noted below, tax-exempt interest should not be included until such time as there is in effect a proven, effective alternative mechanism to provide adequate financing for State and local government needs.

In addition, the allocation of deductions provision of the House bill should be restored for individuals, taking into account the same items of tax preferred income. Allocation of deductions is a sound principle of tax law. It rests on the basis that a person who has both taxable and tax-exempt income can pay his medical expenses, State income taxes, and interest proportionately out of each type of income. For example, if a person has $50,000 salary, $50,000 of tax preferred income, and $20,000 in interest expense and State income taxes, the deductible personal expenditures can be paid, at the option of the taxpayer, either out of his taxable or his tax preferred income. It is plainly incorrect to assume, as does present law, that all of these expenses are paid out of his taxable income and are therefore fully deductible.. Failure to incorporate an allocation of deductions rule will mean that some individuals will get a double benefit from tax preferred income, that is, tax exemption and a tax deduction.

III. Areas of Tax Reform Requiring Further Consideration To Achieve Tax Equity

There are other reforms necessary to achieve a truly progressive income tax. These broad areas, however, require more detailed consideration than could be given by the Finance Committee at this time. The bill does, however, deal with some aspects of these subjects. The discussion below sets out broad guidelines for reform in order that the provisions in the bill can be better evaluated.

STATE AND LOCAL BONDS

Blueprint for reform.—Any effort to institute a truly progressive income tax system must come to grips with the issue of the tax exemption afforded the interest on local government bonds. From the standpoint of Federal tax policy *alone* it is clear that this tax exemption is not justifiable. Tax equity cannot be achieved so long as some people can entirely remove themselves from the tax rolls—or substantially reduce their taxes—by investing in tax-exempt bonds.

However, the problem of providing a guaranteed source of funds for hard-pressed State and local governments must *first* be solved. This must have priority. The failure to recognize this face is the defect in the House bill provisions dealing with tax-exempt interest. The House bill does provide an untried and unproven mechanism by which State and local governments can issue taxable bonds, and thus tap that vastly larger money market. However, it simultaneously subjects tax-exempt interest to tax rules that vary in their impact from investor to investor. In some respects, the uncertainty created by the House provisions insofar as their application to any particular taxpayer is concerned is worse than outright repeal of the exemption.

But in any event, it is clear that tax exemption cannot and should not be ended in any way until there is a trustworthy alternative that offers greater advantages to State and local governments than does tax exemption. The essence and efficacy of our system of government depend upon effective local self-government.

Therefore, the first task in this area of tax reform is development of a viable alternative that frees the State and local governments from the tax-exempt market. For it is increasingly clear that the tax-exempt market is going to be inadequate to permit local governments to meet the challenges of the 1970's and beyond.

There is already evidence available to verify this conclusion. The debt requirements of State and local governments in the next 10 years are predicted to total $30 billion per year in net new borrowings, as the needs for schools, police and fire protection, pollution control, and water supplies escalate. Yet the net new money in the tax-exempt market is currently only $9 to $10 billion per year, and this may be expected to increase to only $15 billion over the next 10 years.

Can the tax-exempt market expand to meet the new demands? Manifestly it cannot. For the tax-exempt market is an inelastic market. It can attract investors only so long as the tax-exempt interest rate combined with the investor's tax bracket produce an investment return at least as favorable as a taxable investment. But, in order to attract new funds on the order required for local government needs, interest rates on tax-exempt bonds would have to rise far above present levels to induce taxpayers in the 20- to 25-percent bracket to invest. This will drive costs to local governments—and thus to local taxpayers—much higher than can be borne.

Another deficiency of the tax-exempt market is its almost total reliance on commercial banks as its source of funds. In 1968, over 90 percent of new tax-exempt bonds were purchased by banks. By investing in tax exempts, banks reduced their effective tax rates from 38 to 23 percent between 1961 and 1968. But how much lower can this rate be taken? Is it reasonable to expect that banks will increase their tax-exempt holdings on anything like the basis required to meet new needs?

Further, total reliance on one source of investor funds is unhealthy for local governments. For in periods of tight money, banks stop buying tax-exempt bonds—or become net sellers—in order to free up funds for customer loans. This happened during 1966 and again during the spring of 1969. It is this factor—not rumors about tax reform—that produced disastrous results for the tax-exempt market this year. And, again, it is the local taxpayer who bears the brunt of this unhealthy reliance on banks. In periods like 1969 his taxes have to go up and up to pay for the ever-increasing interest costs, as counties and States desperately try to keep banks in the market.

Finally, reliance on the tax-exempt market is costly for the American taxpayer. The revenue loss to the Federal Government resulting from the exemption is about $2.6 billion per year. But the benefit of tax exemption to local governments in the form of interest cost savings is only $1.8 billion. Thus all taxpayers pay higher taxes to place $800 million per year in the hands of the wealthest individuals and the banks. This inefficient use of the taxpayer's funds cannot much longer be tolerated. Tax exemption is a form of revenue sharing. If Congress were to adopt a formal revenue sharing mechanism that would pay directly to cities and States $1.8 billion and $800 million to a select few wealthy individuals and some banks, its members would soon be turned out of office by an aroused public. How can the same inefficient and discriminatory practice be justified through the tax system?

On the other hand, it must be recognized that the tax exemption system affords local governments total freedom from Federal control in selecting their projects and it protects their sovereignty. Any alternative solution to tax exemption must meet these same criteria.

It is fairly clear that the answer to these problems lies in opening up the mechanism of the taxable bond market to State and local governments. Only in this way can funds of the magnitude required be obtained. Only in this way can the adverse effects of an inelastic market be circumvented, with resulting cost savings to local taxpayers. Only in this way can the present inefficient tax-sharing system be replaced with an efficient mechanism.

The issuance of taxable bonds by local governments can be accomplished at a reasonable cost with Federal aid. But the form of Federal aid must be such as to insure local governments that Federal aid does not involve Federal control.

There are several different proposals now being considered to provide access to taxable bond markets for local governments. Hearings should promptly begin on these proposals to determine the best system.

Even when a system has been settled on by Congress, no change in the tax-exempt status of traditional municipal bonds should be made until the new system has been in efffect long enough that all concerned—local governments and Congress alike—are convinced that it is a workable mechanism. The faith of local governments in the new system can be readily ascertained by the degree to which they rely on it as a financing vehicle.

In order to insure that Congress will review the mechanism, Congress should determine the extent to which municipal bonds will remain tax exempt at a specified time from the date the new system becomes effective.

CAPITAL GAINS

Blueprint for reform.—Real tax reform must deal meaningfully with the favored treatment presently accorded capital gains. The 1968 Treasury studies revealed that the single greatest factor in preventing our income tax system from being progressive is the provision of our tax laws permitting 50 percent of long-term capital gains to be excluded from income.

The Treasury study showed that a person with an adjusted gross income of between $50,000 and $100,000 pays an average effective rate on his total economic income of 27.3 percent. Yet a person with over $1 million of adjusted gross income pays an average effective rate on his total economic income of only 28.4 percent. The Treasury study also revealed that about 75 percent of the persons with over $1 million of total income are grouped in an effective tax rate bracket of between 20 and 30 percent. About 60 percent of those with incomes between $20,000 and $50,000 fall within this same effective tax rate grouping, although the persons with over $1 million of income have over 50 times as much income.

The major cause of this breakdown in progressivity is the exclusion of a part of capital gains from income and the failure to tax gains on property passing at death. It is thus apparent that if the Cordell Hull principle of progressivity is to be restored to the tax system, consideration must ultimately be given to terminating this preferential treatment of capital gains.

As possible solutions to this major problem, consideration should be given to the following:

1. The taxation of gain on appreciated property transferred at death or by gift on the same basis as gains realized on sales.

2. Repeal of the special alternative capital gains tax rate for corporations.

3. Repeal of the provision permitting 50 percent of capital gains to be excluded from income in the case of individuals. In such a case, the 100 percent of gains so taxed should be fully eligible for income averaging.*

Should the foregoing proposals be adopted, tremendous simplification of the tax laws would result and substantial tax reduction could be granted to all taxpayers.

The removal of the 50-percent exclusion is a step which has far-reaching effects for our economy as well as for our tax system. Therefore,

*The Finance Committee properly rejected the House rule permitting the included one-half of capital gains to be averaged. If capital gains are to be eligible for averaging, 100 percent of the gain must be included in the averageable base.

extensive study should be made to determine those effects and the means by which this change in our tax laws could be effected most equitably and with a minimum of dislocation in the economic plans of taxpayers.

However, there is no reason to delay substantially the first and second proposals outlined above. Taxation of appreciation on property passing at death should be instituted on the same basis as gain is now taxed on sales. The Ways and Means Committee report states that that committee expects to report out a bill on this subject in this Congress. Congress should move next session to close this loophole.

Further, corporations are supposed to be engaged in active trades or businesses and progressive tax rates do not apply; therefore, there is no justification for a special alternative tax rate for gains at the corporate level. Removal of this unjustified tax privilege should be accomplished soon.

CORPORATE EXECUTIVE COMPENSATION

Blueprint for reform.—Closely related to capital gains problems are the tax rules governing the compensation of corporate executives. The tax avoidance devices availed of by these executives are designed to avoid the effects of a progressive tax system.

The Finance Committee wisely retained the House rules changing the tax treatment of so-called restricted stock. These rules should do much to correct this flagrant abuse of the tax system.

It also properly rejected a 50-percent maximum marginal tax rate on earned income that would have benefited corporate executives at tremendous cost to progressivity. This provision would have provided $100 million to less than 30,000 taxpayers, all of whom earn more than $50,000 per year. It must be recognized that loopholes will still remain in our tax laws even after passage of this bill. A corporate executive could completely escape the effects of progressivity by combining remaining tax preferences with the 50-percent maximum marginal rate.

Another aspect of compensation for corporate executives that needs comprehensive revision is that of corporate employee benefit plans—pension plans, profit-sharing plans, and stock option plans. A rational comprehensive system of taxing employee benefits which does not excessively reward high-paid executives at the expense of progressivity—as do present rules—is badly needed. The Treasury has advised that it will submit to Congress a plan for revision of the entire area—including H.R. 10 plans and professional corporations—in 1970.

However, in the case of two types of executive compensation immediate action is required. There is no reason to defer adoption of the proper rule in these cases.

Deferred compensation.—The House bill contains a complex set of rules designed to tax deferred compensation to corporate executives at roughly the same rates they would have paid had they received the compensation on a current basis.

The Finance Committee struck the House provision because of its technical defects. This action was justifiable, but it is a matter of concern that the committee did not substitute a better rule.

The appropriate guide is already in present law. In the case of deferred compensation plans which are funded through a trust agreement, the corporate executive pays tax currently on the compensation so set aside. Now a contract with General Motors is just as safe as a trust. Therefore, so-called deferred compensation should be taxed currently, regardless of whether funded or not, if the employee's rights to the money are nonforfeitable. This will treat all deferred compensation plans alike, and will more closely correlate the rules dealing with restricted stock, pension plans, and deferred compensation.

Lump-sum distributions from qualified pension plans.—Present rules provide that a lump-sum distribution from a qualified pension plan will be given long-term capital gain treatment. This preferred status for this income cannot be justified. It represents compensation: indeed by definition qualified pension plans can only benefit employees. And the corporate employer takes a current deduction for contributions to such plans solely because these amounts do represent compensation.

In addition, those retired employees who receive their pensions in annuity form pay tax at ordinary income rates as the funds are received. The proper way to equate the lump-sum distributee with the annuitant is to tax the lump-sum distributions as ordinary income, with appropriate provision for forward averaging

The House bill takes only a minor step in the direction of achieving tax equity for this income. It does treat as ordinary income—subject to a 5-year forward averaging rule—that portion of the distribution representing the employer's contribution. However, the balance of the distribution—appreciation, dividends, and interest earned by the pension fund—continues to receive capital gain treatment.

The Finance Committee seriously weakened even this modest step. It provides an averaging device—in the name of "simplicity"—that will provide even more favorable treatment for some corporate executives than does the present capital gains rule.

The Senate should adopt a rule taxing the entire amount of a lump-sum distribution from a qualified pension plan as ordinary income (except for the employee's own contributions) subject to 5-year forward averaging rules. In any event, the House bill should be restored without the special rules for averaging adopted by the Finance Committee.

CHARITABLE CONTRIBUTIONS

Blueprint for reform.—Under present rules a taxpayer who gives appreciated property to charity receives a double tax benefit. He gets a charitable deduction for the full fair market value of the property and he excludes the appreciation from income. On the other hand, the person who must make his charitable contributions out of his wage income receives only a single tax benefit. He is entitled to a deduction for his gift, but he includes in income the funds out of which the gift was made.

Almost by definition, the privileged status accorded gifts of appreciated property favors the wealthy and discriminates against other taxpayers. From the standpoint of tax justice, there is no basis for the present treatment of charitable gifts of appreciated property.

Tax reform must ultimately encompass the full taxation of appreciation on property given to charity. Only in this way can gifts of property and gifts out of income, which most citizens make, be treated equally.

The present system does not rest on any rational policy with respect to the relationship of Government and charity. For example, if a 70-percent bracket taxpayer whose income is all from salary gives $100 to his college, the Government bears $70 of that cost. But if his counterpart gives his college a $100 gift of appreciated property, the gift costs the Government $95 (i.e., the $25 in capital gain not paid on the excluded income plus the $70 deduction for the gift). There is no rational reason why the Government should subsidize the two gifts in a different amount.

The above example also provides a clear answer to those who argue that an individual does not make money from gifts of appreciated capital assets. The donor of the appreciated property is clearly $25 ahead of his counterpart who gave out of his income.

Colleges and universities, during the Finance Committee hearings, strongly objected to introducing tax equity into the treatment of charitable gifts by taxing in any manner appreciation on capital assets.

The distressing feature of the stance adopted by colleges and universities was that they did not address themselves to the issue of tax fairness. Their representatives simply asserted that because they were the beneficiaries of an unfair tax system, that system should not be changed. This is precisely the argument made by oil companies for percentage depletion.

Nor did witnesses for the colleges and universities deal with the scope of the problem. Out of over $9 billion in charitable gifts by individuals (for the latest year in which figures are available) only $760 million was in the form of appreciated property—approximately 8 percent. If it were assumed that charitable giving would decline by the full $760 million if appreciation were included in income—which it would not—the question then is whether an 8-percent decline in charitable giving is a reasonable price to pay to achieve tax equity. But on this question, the committee received no assistance.

The colleges and universities also complained that they would be hurt more than other charitable instiutions if tax equity were achieved, because they rely relatively more heavily on gifts of appreciated property. It must be noted that although the factual premise is correct, the conclusion is speculative. But even if the conclusion is accepted, then the question would appear to be: Can we devise an alternative to the present system which will achieve tax equity by taxing appreciation on gifts to charity, but which will not reduce the flow of funds to higher education?

The Finance Committee did not receive the benefit of any testimony directed to this question. Possible alternatives can be posited, however. For example, a matching system might be devised whereby the Treasury would simply pay over to a charity designated by the taxpayer an amount calculated on the basis of the relation of the amount of the donor's charitable giving to his total income. This would be a more efficient system than presently in effect and would involve no more Government controls. The small wage earner would thus have the same incentive to give a significant portion of his total income to charity as would a wealthy individual.

In any event, study of alternatives to utilizing the tax system to encourage charitable giving should be commenced at once—by both the Treasury and the private sector alike.

But all must accept that a truly progressive, truly fair tax system requires ultimately an end to the favored treatment of charitable gifts of appreciated property.

Bill provisions

The Finance Committee adopted a number of proposals in the House bill that make more equitable the tax treatment of charitable gifts. In certain important respects, however, the Finance Committee deleted House reforms that should be restored by the Senate.

(1) *Bargain sales.*—Under present rules a donor can make a "bargain sale" of appreciated property to charity and realize significant tax benefit to himself. If he sells the property to charity at cost, his entire basis is allocated to the sales portion of the transaction. He thus pay no tax on the sale and he gets a full charitable deduction for the appreciation.

Thus, assume a 70-percent taxpayer sells property with a cost of $100 and a value of $1,100, to charity for $100. Not only is the appreciation of $1,000 not taxed, no portion of the sales proceeds are subject to tax either. The net benefit to the taxpayer is thus $950 ($250 of tax that would be paid on the capital gain and a $700 charitable deduction).

Under the House bill, the $100 basis would be proportionately allocated between the sale and gift portions of the transaction. Thus, the donor would pay capital gains tax on $91.91 ($100 less $9.09) and his charitable contribution would be reduced from $1,000 to $908.09 ($1,000 less $91.91). The tax benefit would be reduced from $950 under present law to $862.68. In view of the fact that a proper rule would permit a tax benefit of only $700, the House provision is a modest first step to tax fairness.

The Senate should restore the House provision on bargain sales.

(2) *Gifts of appreciated property.*—The House adopted a rule which applies to gifts of appreciated property consisting of tangible personal property or that are in the form of a future interest in property. Under this rule, the donor could either (1) include the appreciation in income and take a deduction for the full fair market value of the gift, or (2) limit his charitable deduction to the cost basis of property.

The Finance Committee deleted these provisions from the Bill.

The House action was proper in these two situations. In the first place, this will place the two types of gift under equitable tax rules.

Second, there are special reasons to act in the two cases specified by the House without waiting for a general rule applicable to all gifts. In the case of tangible personal property, especially works of art, there are difficult valuation problems, that can be only roughly resolved by subjective judgments. Application of the proper tax rule at the present time will alleviate the valuation problem. In the case of a gift of a future interest, the taxpayer is carving out an income interest usually to benefit himself or his family. When there is this element of substantial self-interest, it appears appropriate to apply the House rule.

FARM LOSSES

Blueprint for reform.—Certain tax rules are generating "farm loss" nontaxpayers similar in type to real estate "tax loss" nontaxpayers. Wealthy individuals have invested in certain aspects of farm operations solely to obtain "tax losses"—largely bookkeeping losses—for use to reduce their tax on other income. The result has been to create a high degree of artificiality in the farm economy.

There are two provisions in present law, designed to assist small farmers, that are utilized by nonfarmers to the detriment of our progressive tax system. The first of these permits a farmer to use the cash system of accounting even though he has inventories. This privilege is not accorded other businesses. Second, the farmer is permitted to deduct currently expenditures that should be capitalized under proper accounting rules.

These tax benefits have been used by nonfarmers most notoriously in the case of cattle and horse raising, citrus groves, and timber. One of the remarkable aspects of the problem is pointed up by the fact that persons with large nonfarm income have a remarkable propensity to lose money in the farm business.

It is important to retain simple accounting rules for true farmers. However, the abuse by nonfarmers of the tax rules designed for farmers should be ended. The following steps would substantially alleviate the problem:

1. All gains on the sale of livestock (including race horses) could be, and probably should be, taxed as ordinary income.
2. The useful life of cattle and horses would be set at not less than 10 years for depreciation purposes.
3. The proceeds from the sale of timber could be treated as ordinary income with fairness.
4. Previously deducted development and improvement expenses should be subject to full recapture on the sale of the land.

Bill provisions

(1) *Disallowance of "loss" deductions.*—The Finance Committee wisely decided to reject the House bill requiring the creation of an excess deductions account (EDA). This is a complex procedure that is largely ineffective in dealing with the "farm loss" problem. The committee's approach is much sounder in principle, since it disallows one half of current "losses" as deductions in excess of $25,000 if a person's nonfarm income exceeds $50,000.

The committee's approach is a step in the right direction. In order to make the provision more effective, however, the dollar limits should be reduced to $10,000 and $25,000 respectively. This step will insure that most nonfarmers abusing the tax laws will in fact be covered, while still excepting legitimate farmers from the special limit.

(2) *Hobby losses.*—The House bill tightened the so-called hobby loss rules which are intended to deny deductions when persons engage in a business activity—such as farming—without any real intention of making a profit from the activity. Their "profit" in such cases is derived from abuse of tax rules.

Present rules dealing with hobby losses are not effective enough to deal with the problem. The House tightened the rules by providing that a person was presumed to be in business without a reasonable expectation of profit if he lost over $25,000 in any 3 out of 5 years. This presumption could be rebutted by the taxpayer.

The Finance Committee substituted a weaker hobby loss provision for the House rule, which may not be even as effective as present law. Under the committee action, the taxpayer is presumed to be in business for profit if he makes *any* profit in any 2 out of 5 years. For example, if a taxpayer times his deductible expenses so that he has $1 of profit in each of 2 years, he will be presumed to be in business for profit even if he "loses" $100,000 in each of the other 3 years. Even present law does not create this presumption for the "hobby loss farmer;" he would have the burden of proving he was in business for profit. Under the House provision, the opposite—and proper—presumption would be created—i.e., that the nonfarmer did not have a reasonable expectation of profit under these circumstances. Furthermore, the committee rule creates a highly undesirable precedent in placing the burden on the IRS of overcoming the presumption. The taxpayer is the one who has the facts and he should carry the burden of showing he intends to make a profit. While the IRS has the burden of proof in cases involving fraud, it does not and should not in ordinary tax cases.

The Senate should restore the House rule.

CONCLUSION

Measured by the yardstick of progressivity there is much in the bill approved by the Finance Committee that can be applauded. There are, however, significant areas in which the Finance Committee bill must be improved. Should the specific steps herein suggested be taken, this tax reform bill will truly stand as a monumental stride toward achieving a progressive and fair income tax system.

ALBERT GORE.

APPENDIX A

TABLE 6.—COMPARISON OF DISTRIBUTION OF TAX REDUCTION UNDER PROPOSAL AND UNDER H.R. 13270

[Calendar year 1969 levels of income]

Adjusted gross income class	H.R. 13270 [1]	$1,000 personal exemption and $1,000 low income allowance [1]
	(millions)	
0 to $3,000	781	965
$3,000 to $5,000	1,001	1,583
$5,000 to $7,000	944	1,943
$7,000 to $10,000	1,286	3,343
$10,000 to $15,000	1,922	3,677
$15,000 to $20,000	806	1,259
$20,000 to $50,000	1,107	1,217
$50,000 to $100,000	464	277
$100,000 and over	657	80

[1] Provisions as effective in tax year 1973 and thereafter.

TABLE 7.—COMPARISON OF NUMBER OF RETURNS MADE NONTAXABLE UNDER PROPOSAL AND UNDER H.R. 13270

Adjusted gross income class	H.R. 13270 [1]	$1,000 personal exemption and $1,000 low-income allowance [1]
	(thousands)	
0 to $3,000	5,149	7,253
$3,000 to $5,000	405	2,168
$5,000 to $7,000	24	1,262
$7,000 to $10,000	8	683
$10,000 to $15,000	4	115
$15,000 to $20,000	2	7
$20,000 to $50,000		
$50,000 to $100,000		
$100,000 and over		
Total	5,592	11,490

[1] Provisions as effective in 1973 and thereafter.

Note: Figures are rounded and do not necessarily add to totals.

VII. SEPARATE VIEWS OF SENATOR VANCE HARTKE

I. Tax Reform

Tax reform is not the responsibility of any one committee. As a member of the Senate Finance Committee, I welcome complete and adequate consideration of various tax reform proposals by all Members of the Senate on the Senate floor. Tax reform is too important to be left to the committee system. I would like to suggest briefly areas that I believe should be considered more thoroughly.

NATURAL RESOURCES

One cannot talk about tax reform unless one talks about oil.

Certainly the oil industry is integrally involved in our national security, and there is a need to develop and preserve a certain amount of oil reserve. These valid claims, however, have been used to justify, not just one special governmental preference, but a whole series of preferences that working in combination have created truly unconscionable Federal subsidies to the oil industry.

The oil industry's Federal tax payments are just too low.

Also, certain recent events raise serious questions about some of the standard assertions of the oil industry. The discovery of oil in Alaska must change our previous estimates of oil resources. Recent studies conducted for the Treasury Department reveal that Federal policies toward the oil industry, while extremely costly to the Government, contributed only to a marginal increase in our oil reserve. In fact, the cumulative effect of present Government policy may contribute to inefficient and costly practices in the oil industry. The hearings of the Senate Subcommittee on Antitrust and Monopoly demonstrate that Government policies toward the oil companies constitute a substantial disservice to other industries and the general public. For example, it has been estimated that the cost to the public of the import quota system alone runs to about several billion dollars. An evaluation of Government policy should consider not only one industry, but also the effect on our entire society.

The depletion allowance is supposed to be somewhat similar in purpose to depreciation allowances provided to other industries. In practice, there are startling differences. According to estimates of the Treasury Department, depletion allowances frequently average 12 times the actual cost.

It seems clear to me that our present system of tax preference to the natural resources industries is failing to achieve its alleged goals and is allowing the petroleum industry in particular to escape a substantial portion of its tax obligation. For these reasons I not only support the reduction of the percentage depletion allowance to 20 percent, but also I will propose that the depletion allowance be further reduced.

FOREIGN TAX CREDIT

The two sections of the House bill dealing with foreign tax credit were eliminated by the Senate Finance Committee. These provisions should be restored. Certainly foreign tax credit is one of the most complex areas in the entire tax code, but enough is known to justify restoring fully the two House provisions.

FARM LOSSES

The Senate Finance Committee wisely dropped the excess deduction approach contained in the House bill, but it established such high-dollar figures before these farm loss provisions apply that they will have little effect. The dollar figures in the farm loss provisions should be lowered. In numerous ways the Senate committee loosened many of the provisions relating to hobby farmers. These hobby farmer provisions should be strengthened on the Senate floor. Also, farm losses should be included as a preferred item in the minimum income tax provision.

MINIMUM TAX

Theoretically, all items of preferred income should be included in a minimum tax provision. Because of the strong case made by municipalities, colleges, and charities, appreciation of charitable gifts and interest on municipal bonds were excluded from the minimum tax provisions. The minimum tax provision provision is one of the most important in the bill. It brings some measure of equity to our tax system. The minimum tax, however, should not be used to achieve substantive tax reform. Each area of tax reform should be considered on its own merits and the issues squarely faced.

WITHHOLDING OF INTEREST AND DIVIDENDS AT THEIR SOURCE

Present law requires the withholding of taxes only on income from wage and salary. There is no comparable requirement applicable to interest and dividends. This is just one more example of the preferred tax treatment given to the wages of money over the wages of men. I favor an amendment which would require that Federal income tax on interest and dividends be withheld at their source.

APPRECIATED VALUE TRANSFERRED AT TIME OF DEATH

Gains on stocks, real estate, and other appreciated assets transferred at death now escape income taxation. In addition, the basis of the asset for tax purposes is stepped up to market value at the time of death.

Thus, in any subsequent sale by the heir, no tax is paid on the increase between the basis of the asset in the hands of the decedent and the market value at the time of death. I favor an amendment that would provide that assets transferred to heirs be transferred at their original purchase value. If this were done, the heirs would pay capital gains on all the appreciated value.

II. Tax Relief

It is imperative that we provide some measure of tax relief for the average American. Unfortunately, the tax relief in the Senate Finance Committee bill gives too much to taxpayers who do not need it and not enough to those who should have more relief. Using figures provided by Leon Keyserling, former Chairman of the Council of Economic Advisers and not considering the reform provisions, whose future remains uncertain, taxpayers with income of $50,000 and over, representing only 0.5 of the total tax returns, would receive 13.4 percent of the tax cuts. Considering a percentage increase in after-tax income, there is the same picture of unnecessary tax relief for the wealthy and inadequate tax relief for the lower income tax payer. In the $5,000 to $10,000 bracket, taxpayers receive only slightly more relief than those in the $10,000 to $20,000 income bracket, substantially less than taxpayers in the $20,000 to $50,000 group, and shocking less than taxpayers with income of $50,000 and above. Using this standard of comparison, the tax relief provision provides immensely more favorable treatment for taxpayers above $50,000 income than any other group. I do not think that aid to the wealthy is what is meant by tax relief. These provisions only add to the presently grossly inequitable tax code.

We must concentrate tax relief on the lower and middle income-tax payer. To accomplish this purpose, Senator Gore and I offered an amendment raising the personal exemption to $1,000. This amendment received only three votes in executive session of the Senate Finance Committee. Various other amendments for raising the personal exemption were offered in executive session, but all failed to pass the last by a tie vote.

I will continue this battle to raise the personal exemption on the Senate floor. Increasing the personal exemption to $1,000 is the quickest and easiest way of providing tax relief for most Americans. The level and pattern of family exemptions in the United States have undergone many changes since 1913 (see table 1). The present equal per capita arrangement was started in 1914. The $600 per capita exemption was started in 1948.

TABLE 1.—MAJOR CHANGES IN FEDERAL PERSONAL EXEMPTIONS SINCE 1913

Year	Single persons	Married persons: Amount	Married persons: As percent of single persons' exemption	Children: Amount	Children: As percent of single persons' exemption
1913	$3,000	$4,000	133		0
1917	1,000	2,200	200	$200	20
1921	1,000	2,500	250	400	40
1925	1,500	3,500	233	400	27
1932	1,000	2,500	250	400	40
1940	800	2,000	250	400	50
1941	750	1,500	200	400	53
1942	500	1,200	240	350	70
1944	500	1,100	200	500	100
1948	600	1,200	200	600	100

Source: Table contained in Federal tax treatment of the family by Harold M. Groves.

Today, the $600 exemption is ludicrously inadequate and is more of an insult than a benefit to the American taxpayer. Since that figure was first adopted, the cost of living has increased by 40 percent. To expect the American taxpayer to provide the basic minimum necessities of life for himself, his wife, and his children on $50 per month each is as unrealistic and antiquated as crossing the Atlantic in a sailing vessel.

What is the basic purpose of these exemptions?

There have been differing views, but probably the most common view, and the one to which most of us hold, is that taxes should not be applied to the income of persons until their minimum basic needs have been allowed for. It was in 1948 that the last change in the amount of the exemption was made. At that time it was increased from $500 to $600, the $500 rate having been adopted in 1942 under wartime need for increased tax income, a reduction from $750. Thus we have never returned even to the prewar situation, let alone modernize the tax exemption in accord with more recent cost of living changes.

In 1947, the Treasury Department produced a study of individual income tax exemptions, which included as an appendix a consideration of "Function and Purpose of Individual Income Tax Exemptions." Under a section discussing minimum living standard, there appears this paragraph:

> According to a widely accepted view, the exemption should be at least adequate to cover some minimum essential living costs, such as the amount required for reasonable maintenance. It is conceded that the adjustment of exemptions to living costs may not be exact and that under emergency conditions it may be necessary to go below ordinary minima. For the long run, however, it is to be regarded as essential to exempt amounts required to maintain the individual and his family in health and efficiency.

You will note that the Treasury, in this wartime era, spoke of going "below ordinary minimums" as only a temporary procedure, that it might be necessary "under emergency conditions." Certainly those emergency conditions have long since passed, the economy has prospered, the cost of living has risen drastically—but the $600 remains where it was 20 years ago.

Under the concept of the income tax, with the exemption's purpose being that of allowing an untaxed minimum for health and efficiency, the Treasury study says:

> Ability to pay does not commence until a point is reached in the income scale where the minimum means of life have been obtained.

What is that minimum means of life today? How does it compare with the minimums left untaxed for the average American family?

In 1948, when the $500 was raised to $600, a family of four had an exemption of $2,400. But these were 1948 dollars. To be equivalent because of dollar inflation alone, moderate as it has been year by year, the sum would now need to be $3,288, or $822 per person.

But what were average incomes like in those days? Fortunately, wages are not only much greater today, but living standards—acceptable minimums for family life—are also much greater. This is reflected in a study released in March of this year by the Department of Labor, measuring the income needed for a family of four. This is a revision of the work produced in the fall of 1959 dealing with city workers' family budget estimates. That budget measured the needs of a family of four—an employed husband aged 38, a wife not employed outside the home, and two school-age children, a boy of 13 and a girl of 8. It was not a luxury or ideal budget but was described as one presenting a "level of adequate living according to standards prevailing in large cities of the United States in recent years."

As an example of the kinds of items calculated, the budget assumes for the husband the purchase of five shirts a year and not quite two pairs of shoes annually. The wife's dress allowance is about 2 and a half new dresses a year. The budget allows not for new cars but for the purchase of a used car every 4 years—and for only 80 percent of most city families.

U.S. average annual cost in spring of 1967 was $9,076 for total budget and $7,221 for cost of goods and services in the budget. Because of increases in prices, it has been estimated that the cost of the same costs and services in autumn of 1968 would have been about $7,630. Of the total, food accounts for $2,235; housing was $2,311, transportation, $912; clothing and personal care, $1,069; and medical care, $520.

Other economic studies have placed the needs oi families in the same general range within the last 2 or 3 years. For a two-person family, the same calculations give a minimum of $4,690, and for a family of five, with the oldest child not over 16, the total budget comes to $8,020.

This, of course, is considerably more than the amount that many thousands and even millions of families have as income; $3,000 is often cited as the poverty line. Yet our present $600 exemption provides only $2,400 deductible for a family of four. A $1,000 exemption for four persons would still be more than 50 percent below the family budget I have been noting.

The times have changed. This is no longer 1948, and a lot has happened to the economy in the last 20 years to make features of that era outmoded. Outmoded certainly is the $600 exemption, unrealistic, inequitable, an undeserved penalty for the taxpayer who is in the lower brackets. To refer once more to the Treasury paper I have cited:

> Perhaps the major function of the exemptions is to determine minimum levels of income subject to tax.

We are in all too many instances today taxing the poor, those whose incomes are below the income level needed for adequate living standards of decency, perhaps even for some who are below the income level which we designate as that of poverty. It is time we stopped taxing the poor and gave them an equitable share in the prosperity of the Nation. An exemption of $600 per person—I might remind you also that until 1939 it was $1,000 for a single person and $2,500 for a married couple without children is unrealistic and unfair. It should be changed to $1,000.

While increasing the personal exemption to $1,000 is both desirable and necessary, it may prove impossible to achieve on the Senate floor. President Nixon has already suggested that he will veto a greatly unbalanced bill—i.e., a bill that loses more tax revenue than it generates. A $1,000 exemption, even spread over a series of years, will result in an unbalanced bill.

In the event that the amendments to increase the personal exemption to $1,000 fails, I will offer an amendment which will provide much more equitable tax relief but will not result in any more tax revenue loss than the bill approved by the Senate Finance Committee. This amendment would establish a minimum standard deduction phased in on the same basis as the Senate proposal for low-income allowance, coupled with an increase in the personal exemption to $650 in 1970, $700 in 1971, and $800 in 1972. The following tables indicate some of the consequences of this amendment:

TABLE 2.—ANNUAL REVENUE LOSS FROM RELIEF MEASURES

[In billions of dollars]

	1970	1971	1972
Senate [1]	1.7	5.1	9.0
Hartke [2]	2.3	5.0	9.0

[1] Includes when applicable: Rate reductions, low-income allowance (minimum standard deduction), singles and standard deduction.
[2] Includes: $800 personal exemption ($650 in 1970, $700 in 1971, and $800 in 1972) and minimum standard deduction phased same as Senate proposal.

TABLE 3.—DISTRIBUTION OF TAX RELIEF BY INCOME GROUPS

[In percent]

Adjusted gross income	House	Senate	Hartke proposal	Percent of taxpayers in income bracket
0 to $3,000	8.5	8.6	10.1	16.0
$3,000 to $5,000	11.3	11.4	14.6	15.1
$5,000 to $7,000	10.8	10.9	15.4	15.5
$7,000 to $10,000	14.6	14.8	21.9	21.9
$10,000 to $15,000	21.1	21.3	21.8	20.7
$15,000 to $20,000	8.6	8.7	7.3	6.1
$20,000 and over	25.0	24.3	8.8	4.7
Total	100.0	100.0	100.0	100.0
Revenue loss (millions)	$9,273	$8,968	$8,991	

Note: Foregoing proposals make following allowances:
House: Low-income allowance, elimination of phaseout, standard deduction, general rate reduction, maximum tax, and intermediate relief.
Senate: Low-income allowance, elimination of phaseout, standard deduction, general rate reduction singles.
Hartke: $800 personal exemption plus $1,100 minimum standard deduction.

TABLE 4.—FEDERAL INCOME TAX BURDEN—PRESENT LAW COMPARED WITH THE HOUSE AND SENATE REFORM BILL, AND HARTKE PROPOSAL [1] (MARRIED COUPLE, 2 DEPENDENTS ASSUMES DEDUCTIBLE EXPENSES OF 15 PERCENT OF INCOME)

	Total tax			Amount of tax reduction			
Wage or salary income	Present	House and Senate	Hartke proposal	House and Senate	Hartke proposal	House and Senate (percent)	Hartke proposal (percent)
$3,000	0	0	0				
4,000	$140	$65	0	$75	$140	53.6	100.0
5,000	290	200	$98	90	192	31.0	66.2
7,500	691	576	480	115	211	16.6	30.5
10,000	1,019	958	867	61	152	6.0	14.9
12,500	1,430	1,347	1,271	83	159	5.8	11.1
15,000	1,897	1,794	1,721	103	176	5.4	9.2
20,000	2,910	2,738	2,710	172	200	5.9	6.9
25,000	4,058	3,829	3,834	229	224	5.6	5.5
50,000	12,188	11,504	11,825	684	363	5.6	3.0
100,000	34,858	32,292	34,384	2,566	474	7.4	1.4

[1] $800 personal exemption and $1,100 minimum standard deduction.

Note: Assumes deductions equal to 15 percent of income, or minimum standard deduction (low-income allowance)—whichever is greater. Surtax excluded.

This amendment clearly concentrates tax relief among the lower and middle income taxpayers. It couples an increase in the personal exemption rates with a substantial increase in the minimum standard deduction. For the taxpayer in the $7,000 to $10,000 income bracket, my proposal will provide 21.9 percent in tax relief compared with only 14.8 percent relief in the Senate Finance bill. For taxpayers in the $10,000 to $15,000 bracket, my proposal provides for 21.8 percent tax relief compared to 21.3 percent provided by the Senate Finance bill. Taxpayers in these and lower tax brackets desperately need this tax relief because they bear a disproportionate share of the existing tax burden, endure the full brunt of the present high tax and high interest rate policies and pay more than their share of the highly regressive State, local, and property taxes.

If the attempt to increase the personal exemption fails on the Senate floor, and I do not believe it will, I will offer an amendment that I also offered in executive session, but which failed to pass 10 to 7. This amendment does not affect the low-income allowance provisions or the provisions increasing the standard deduction. It does, however, redistribute the relief provided by rate reductions and concentrates such relief among the lower income and middle income Americans. I will offer the proposed change in the rate as follows: the 14 percent rate cut to 9 percent; the 15 percent rate cut to 13 percent; the 16 percent rate cut to 15 percent; the 17 percent rate cut to 16 percent; the 19 percent rate cut to 17 percent. Every taxpayer would receive a tax reduction, but the bulk of the tax relief would be concentrated among lower and middle class taxpayers. Assuming the proposed rate changes as indicated above, my proposal, contrasted with the committee bill, would affect certain income levels as follows:

For a couple with two dependents, $7,500 in income, the Senate Finance bill provides $111 in tax reduction; my proposal would provide $161. For a couple with two dependents, $10,000 income, the committee bill provides $156; my proposal provides $206. With an income of $12,500, the committee bill provides for $220; my proposal would provide for $267. With an income of $15,000, the committee bill provides for $216; my proposal provides for $240. While I hope for a great deal more, this is the very least that should be done.

III. The Surtax and the Economy

The present inflation is not caused by an overheated economy, but rather by overheated prices caused by a series of unplanned Government deficits and exacerbated by a tight-money and high-tax policy. The surtax is not needed to increase pro tanto the size of the Federal surplus in order to restrain an overheated economy in the sense of an economy where aggregate demand exceeds available productive resources. As a matter of fact, the economy viewed as a whole has been in a state of virtual stagnation for more than 3 years (mid-1966 to late 1969), quite similar to the stagnation which preceded recession three times during the Eisenhower years. The real economic growth rate was only 3.3 percent from second quarter 1968 to second quarter 1969; only 2.5 percent from third quarter 1968 to third quarter 1969; and at an annual rate of only 2.1 percent from second quarter 1969 to third quarter 1969. The fact that plants are only operating on an average of 84 percent capabilities belies the assertion that there is an overheated economy. The present inflation, to a very large measure, is driven by the fact that the economy is not performing adequately in real terms.

The present policy of tight money and rising interest rates add to the repression of the real economic growth of the U.S. economy while adding greatly to inflation itself. Inflation is an increase in the cost of obtaining something. An increase in the price of steel enters into more products, and thus an increase in the price of steel increases the price of housing, automobiles, household durables, roads, and so forth. But borrowed money is used for even more diversified purposes, and therefore an increase in the price of borrowed money leads to price increases all along the line. It forces up wages because the wage earner finances so much of the cost of living with borrowed money. Because housing is so tremendously financed with borrowed money, the rising cost of money has contributed greatly to the fact that the rising cost of rental housing and homeownership has been one of the greatest factors in the rising cost of living. The utilities are being forced toward rate increases across the board because aside from housing they depend more upon borrowed money than any other industry.

It is argued that the rising cost of money reduces its use for purposes of business activity and that this reduction is anti-inflationary. The argument that an increase in the price of money reduces its use is neither more nor less valid than the argument that an increase in the price of steel or an increase in the price of food decreases their use. Thus, the whole argument reaches a ridiculous posture that inflation across the board is the best cure for inflation. Moreover, a rise in the cost of money allocates the use of money in ways which are absolutely perverse to our great national priorities—housing, and all public improvements and services based upon public borrowing being the best example. The current anti-inflationary policy, conspicuously failing to curb inflation, is placing enormous interest charges on the shoulders of consumers, small businessmen, and farmers. The present policy is a form of usury on those less able to pay. A policy of high interest rates is being passed on to the consumer in the form of higher prices.

Also, the surtax is highly undesirable because it applies the same percentage of increase across the board. This is in fact highly regressive and is undesirable at all times, but especially undesirable in view of the regressive nature of the tax bill in its present form.

The Administration is applying classic economic policy which might work in other countries, but not in the United States. Our economy is too dynamic for the application of outmoded textbook theory. The greatness and the distinctive characteristic of the American economy are its unprecedented technological development and productivity and unmatched standard of living. We should understand the uniqueness of our economy and apply economic theories consistent with its characteristics. The United States needs an economic theory of growth, not classic economics but creative economics. The Federal Government should develop a policy that encourages investment in technology and fosters an economic distribution of income that insures demand. Frequently, economic analysis emphasizes one part of the economy while disregarding the rest. The economy is not static, and each part is not independent. Rather, it is fluid, and its parts are dependent and interrelated.

Present economic policy applying old economic theories to a new economic situation is creating a new economic phenomenon—price inflation coupled with actual economic recession.

IV. Investment Tax Credit

The investment tax credit was established in 1962 because the U.S. expansion and modernization of its plants and equipment were totally inadequate. It was enacted after months of intense debate on what should be done to increase this Nation's sluggard productivity, strengthen the economy, and enhance our products' competitiveness here and abroad. For years before 1962 economists had discussed the need for depreciation reform to encourage modernization of our industrial plants. Modernization had been hindered by rising replacement costs and made urgently necessary by the much more liberal depreciation practices of most other industrial nations. These conditions that necessitated the tax credit continue to exist today.

Therefore, the investment tax credit was conceived and enacted as a permanent incentive to capital spending deemed necessary for the growth and vigor of our economy.

This was made quite clear by Secretary of the Treasury Douglas Dillon, who stated:

> I consider our program of depreciation reform—including the investment credit—a central part of our economic policy * * *. It is my conviction that depreciation guidelines and investment credit are not only the best way to bring about a higher investment level but are absolutely necessary if we are to grow at a more rapid rate and maintain a widespread international confidence in our currency.

Assistant Secretary of the Treasury Stanley S. Surrey stated in a speech on March 12, 1962:

> The fact that the investment credit was suggested at a time when we were in a recession period and the fact that it is being adopted in a period of recovery does not mean that it is to be regarded as a countercyclical tool. Rather it is intended to be a permanent part of our basic tax law.

Two points should be clear: first, the investment tax credit was not a response to a temporary recession and was not considered a tool to manipulate the economy. The Council of Economic Advisers stated in 1961 before the Joint Economic Committee:

> Measures to stimulate business investment directly will contribute to our recovery from the present recession, but that is not their main purpose. All who have confidence in the American economy must look ahead to the day when the slack will be taken up and high levels of output and employment will again be the rule. The full benefit of our decision to supplement increases in consumer demand now with a higher rate of capital expansion and modernization will then be realized.

Secondly, the investment tax credit was adopted as a permanent solution to the longstanding and long-term problems of productivity.

Secretary Dillon stated to the Senate Finance Committee in 1962 that the tax credit "must be a permanent part of our tax code as opposed to all temporary remedies for recession."

American industries made many long-term investment plans based on these assurances of the permanency of the credit. This reliance in official government statements did not seem entirely unwise. As late as March of this year, Secretary of the Treasury Kennedy publicly stated:

> We have no plans for tindering with the investment tax credit. Congress intended the credit to be part of the regular tax system and not a device for stimulating or slowing the economy.

Less than a month later on April 18, the Administration proposed the total repeal of the credit. Improvisation is not a wise method of reaching economic decisions. Reacting solely to conditions at any particular moment is a form of economic reflex having only a trickster's chance of being correct. The investment tax credit is the result of sound economic thinking, and it or some comparable alternative should be continued.

The repeal of the investment tax credit is justified in part as being necessary to curb inflation. The impact of the removal of the credit, however, cannot possibly take effect until the last quarters of 1970 and early 1971. Projects on which there are firm commitments will go on regardless of the repeal of the credit. Also, there is a technical lag of at least 12 months on the average between the time an investment decision is made and the equipment is produced. By that time, repeal will not be needed or will be hopelessly inadequate to control inflation.

Viewing repeal of the credit as anti-inflationary results from a one-sided concentration on demand, disregarding the importance of supply in any economy. The classic answer to rising prices for goods and services has been to increase the supply sufficiently to bring prices down. Repeal of the investment tax credit will decrease the ability of industry to add to the supply.

The most significant causative factor for our present inflation was the unanticipated and unplanned cost of the Vietnam war, resulting in bloated budgetary deficits.

The credit has not been and is not a significant factor in causing inflation.

For example, in manufacturing as a whole, prices of both durable and nondurable goods have risen much less than overall consumer prices over the same period. Also, prices of manufactured goods have risen only about a third as much as hourly wage rates over the same period. The lower rise in prices for manufactured goods was made possible by substantial investments in new equipment since 1962.

Overall expenditures for capital investment are not inflationary. Pierre Rinfret, a noted economist and adviser to President Nixon during the campaign, estimates that in real noninflationary terms, our private capital investment did not rise from 1966 to 1968, and the real rise in 1969 is going to be small. At the beginning of this year, it was estimated that capital expenditures for new investment would be

14 percent higher than last year. Today it is quite obvious that capital expenditures will be much less, perhaps only 7 to 8 percent higher. It should be remembered that inflated prices distort these figures. In terms of constant dollars, the present expectation for an increase in capital expenditures this year will probably be no more than 4 percent. A 4-percent increase in expenditures for plant and equipment is neither inflationary, nor even adequate for our inevitably growing economy.

Of course, in our presently tight economy any increase in spending is to some extent "inflationary." Unlike most other forms of spending, however, spending to expand productivity offers the hope of breaking the present cost-push inflationary cycle. In our present tight economy, with no attempt by the Administration to influence prices or wages, the continuing improvement of our industrial capacity by the introduction of cost-cutting productive equipment would seem to be the only factor driving costs and prices down. Are we to stop inflation by increasing unemployment or by increasing productivity?

Clearly, in the long run the investment tax credit is anti-inflationary. Our Nation has always been, compared with other countries, a higher labor cost economy. Our standard of living is the marvel of the world, but it rests on a foundation of productivity. If our productivity contracts or is sluggish, our standard of living will inevitably fall.

Expenditure on capital equipment not only expands productivity, but also eases pressure on costs and prices. As Mr. John O'Riley wrote in the Wall Street Journal (May 12, 1969, "The Outlook Column"), "Over the long pull, no force on earth has done more to hold down the prices of things people buy than has capital spending."

Finally, retention of the investment tax credit is fully consistent with our social goals and sense of national priorities. In the last year, 2 million Americans were lifted from poverty. While unquestionably many Government and private efforts helped, it was reported that the expanding economy was primarily responsible for lifting these Americans from poverty. In view of Dr. Arthur Burns, the real growth of the economy has done more for employing and raising the living standards of the American poor than all the Government poverty programs put together.

Isolationism is no more appropriate for economic decisions than it is for political decisions. Before the tax credit was adopted, extensive studies revealed that the capital investment of most industrial countries far exceeded that of the United States.

Advocates of repeal of the tax credit refer only infrequently to foreign competition and submit no evidence that the problem which seemed so urgent in 1962 has disappeared in 1969. In fact, the problem that existed in 1962 has grown more pronounced in 1969. A recent study by McGraw-Hill, Inc. indicates that the United States today has the highest percentage of overage, obsolescent production facilities of any leading industrial country. Also, a study of U.S. investment from 1960 to 1968 revealed that the United States continues to have the lowest ratio of capital investment to gross national product of any of the major industrial nations. Specifically, our average over this 8-year period was 16 percent while that of Japan was 33 percent and West Germany's was 25 percent. Also, many of our foreign competitors continue to have much more favorable tax policies and incentives for capital investment. The disparity between foreign capital investment and U.S. investment continues.

Pierre Rinfret prepared the following chart of capital expenditures for 1969 over 1968:

CAPITAL EXPENDITURES GAINS—1969 OVER 1968—SURVEY RELEASE

[In percent]

	Late 1968 or early 1969	Most recent
Western Germany	+10	+25
France	+14	+19
United Kingdom	+10	+15
United States	+14	+13

It is obvious that while we decrease our capital investment, our foreign competitors increase theirs. Such a pattern offers little hope of improving our steadily declining balance of trade.

It is reported that Japan, the world's fastest growing economy, is deferring approximately one-third of its potential consumption in order to invest in increased capacity and lower cost production facilities. There is an obvious connection between Japan's capital investment and the increasing success of its exports in the United States.

Japan's export of automobiles to the United States rose from 70,000 units in 1967 to 170,000 units in 1968 and will probably exceed 250,000 units this year. Japan's steel exports to the United States increased from 4,700,000 tons in 1967 to 7,500,000 tons in 1968. By 1971 the Japanese steel industry will be producing in excess of 100 million tons of steel. They will have at least four individual mills capable of producing 11 million tons of steel. The United States will not have a single similar mill by 1971.

Obviously, something must be done about such competition. Everyone talks about free trade, but few seem willing to implement measures that will make free trade possible. With our high standard of living and high labor cost, does anyone believe we can compete with foreign producers in labor costs? If the United States is to compete in the world markets, we must have higher productivity, made possible by the most modern techniques and equipment.

The investment credit is one of the very few measures assisting American industry to remain competitive with foreign producers. Free trade will not be achieved by passionate prayer.

The future necessity for a high level of capital spending was recognized by President Nixon when he stated on April 21, "* * * A vigorous plan of capital formation will certainly continue to be needed * * *"

I agree with this conclusion. An expanding population, a shortage of skilled manpower, and continued exposure to world trade makes the investment credit as necessary for the future as it was for the past. To consider just one demand that will be made on our economy, it has been estimated that an average of 1.4 million new jobs will be required annually during the 1970's. In the coming decade, 14 million new jobs must be created. These jobs can only be created by a rapidly expanding economy.

Economic forecasts have frequently underestimated this Nation's potential growth. Failure to provide an adequate industrial capacity will create a situation of short supply, high-cost production, and higher prices. We must adopt sound economic policies enhancing productivity that will allow us to view the future as an opportunity, not as a problem.

V. Vietnam and the Economy

One cannot analyze properly the present economic situation unless one considers the costs of the Vietnam war and our past and present method of financing that war. Government outlays for military goods rose from $50 billion in 1964 to an estimated $79 billion in 1968, a 12 percent annual rate increase. Total real output grew at a 5 percent rate during this period, so that a steadily greater proportion of the Nation's production was utilized in the defense effort. It should be remembered that sudden increases in defense spending are more inflationary than similar increases in nondefense Government spending because they do not add to our domestic resources or efficiency. The real cost of the Vietnam war is probably incalculable because of the intangible cost to our economy such as lost opportunities and the further shift to defense production away from consumer production. More important than the actual increases, is how these increases were financed.

In fiscal year 1967, there was an anticipated deficit in the administrative budget of $1,847 million. The actual deficit for fiscal year 1967 was $9,869 million. While fiscal year 1967 was a fair-size mistake fiscal year 1968 was a gigantic mistake. The anticipated budget deficit for fiscal year, 1968 was $8,096 million. The actual deficit was $28,386 million. Since the Administration did not want to acknowledge that it was fighting a war, it is understandable that it was reluctant to finance it. This series of deficits caused by Vietnam and the unwillingness to plan for the cost of Vietnam are what started the present inflation and high interest rates. In Government's desperate attempt to finance these totally unplanned costs, it seriously distorted the money markets. This distortion of the money market continues today. No previous war has ever been financed by a tight money policy. Every war has been financed by an easy money policy. In previous wars Government policy has been to try to hold interest rates down so that the future national debt burden will not be financially crippling for coming generations. The exact reverse policy is being pursued for the financing of the Vietnam war. Deliberately established high interest rates are creating a monstrous future debt service. Because of the unwillingness to face the realities of financing a war, billions and billions of dollars are being added to the national debt. In such a situation, inflationary expectations are correct. Unless we change our present monetary and fiscal policy, the only way to end present inflationary expectation is to end the Vietnam war.

Vance Hartke.

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