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BY THE

COMMITTEE ON FINANCE

RUSSELL B. LONG, *Chairman*

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A. Private Foundations

1. Limitation on Life of Foundations

Present law.—Under present law, there is no limitation on the period for which a private foundation or other exempt organization may be exempt from income tax.

Problem.—Questions have been raised as to whether private foundations should have a permanent exemption from income tax. In part, the problem here is that if foundations have a permanent life, their economic power may increase to such an extent that they have an undue influence on the private economy and on governmental decisions as well. Secondly, since income (or estate or gift tax) exemptions were granted for amounts given to these foundations and the basis for this deduction 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.

Finance Committee decision.—To deal with the problems described above, the Finance Committee adopted an amendment limiting the period of the income tax exemption for private (nonoperating) foundations to 40 years.

In the case of existing foundations, this 40-year period would begin with January 1, 1970. For foundations created in the future, the 40-year period begins with their creation or initial treatment as a tax-exempt private foundation.

A private foundation remaining in existence as a nonoperating foundation after 40 years (whether or not consecutive) is to be taxed in the same manner as an ordinary taxpayer (except that if the combination of the audit-fee tax and the unrelated business income tax is higher, these taxes would continue to be paid), but in addition is to remain subject to all of the provisions relating to foundations (self-dealing, distribution of income, etc.). Contributions to such an organization will not be deductible after the 40 years. A private foundation could escape taxation as a regular corporation after the end of the 40 years by being converted into an operating foundation or a publicly supported educational, charitable, or religious organization, or by distributing all of its assets to one or more operating foundations or a publicly supported educational, charitable, or religious organization.

The House bill contains no comparable provision.

2. Audit-Fee Tax

Present law.—Although present law subjects many exempt organizations to taxation on unrelated business income, their investment income is specifically excepted from this tax.

Problem.—Questions have been raised as to why private foundations should not pay some of the cost of government, especially the funds needed for more extensive and vigorous enforcement of the tax laws relating to exempt organizations.

Finance Committee decision.—The Finance Committee decided to deal with this problem by imposing on private foundations an audit-fee tax of ⅕ of 1 percent (based upon the fair market value of the assets held by the foundation), or $100, whichever is the greater. The assets used by a foundation in the active conduct of its exempt functions would not be included in the base for this audit-fee tax. The assets would be valued and averaged in the same manner as is provided for determining the base upon which the minimum investment return is calculated. The committee views this tax as a supervisory fee and as an indication of the amount of the funds needed by the Internal Revenue Service for the administration of the Internal Revenue Code provisions relating to private foundations and other exempt organizations.

The House bill would have imposed a tax equal to 7½ percent of investment income. That tax in the average case would have represented approximately twice as heavy a tax burden as the audit-fee tax provided by the Finance Committee amendments.

3. Prohibitions on Self-Dealing

Present law.—Under present law, no part of the net earnings of private foundations and other charitable organizations are permitted to inure to the benefit of private shareholders or individuals, Also, 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.

Problem.—Arm's-length standards have proved to require disproportionately large enforcement efforts, resulting in sporadic and uncertain effectiveness of the provisions. Moreover, the subjectivity involved in applying such standards has occasionally resulted in the courts refusing to uphold sanctions, especially when they are severe in relation to the offense. In other cases, the sanctions have practically no deterrent or punitive effect even where there is vigorous enforcement. Also, many benefits may be derived by those who control a private foundation even though they deal at arm's length.

Finance Committee decision.—The Finance Committee amendments, like the House bill, replace the arms-length standards with a list of specific transactions which constitute prohibited self-dealing when engaged in between the foundation and disqualified persons. Self-dealing transactions, as in the House bill, include the sale or exchange or leasing of property between the private foundation and a disqualified person, the lending of money or other extension of credit between such persons, the furnishing of goods, services, or facilities between such persons, the payment of compensation by a private foundation to disqualified persons, the transfer to or use by, or for the benefit of, disqualified persons of the income or assets of a private foundation, the payment of money or other property to a government official, and the payment by a private foundation of a tax imposed on a disqualified person as a result of these new provisions. Except for the last item in this list, which was added by the Finance Committee, the provisions are the same as under the House bill. The Finance Com-

mittee, however, also clarified the self-dealing provisions to make it clear that where a private foundation sells stock to a disqualified person in order to comply with the divestiture rules (described subsequently), this is not to constitute self-dealing even though the sales price is reduced by sales commissions which would have been paid had the stock been sold in the open market. The committee also made it clear that self-dealing may occur even without the transfer of money or property between the foundation and the disqualified person. This can occur, for example, where the stock is bought or sold by the foundation in order to manipulate the price of the stock for the benefit of the disqualified person.

A special rule was applied by the Finance Committee in the case of leases and loans outstanding on October 9, 1969, and also where, under arrangements in existence before that date, goods, services, or facilities were shared by a private foundation and a disqualified person. In all such cases where the foundation receives terms at least as favorable as terms offered to third parties in arms-length transactions, the existing arrangement (under the same or a new lease, loan, etc.) can continue for a period of up to 10 years.

Under the House and Finance Committee version of the bill, a violation of the self-dealing provisions results in an annual tax on the self-dealer of 5 percent of the amount involved in the violation. If the self-dealing is not corrected within an appropriate time, then a tax of 200 percent of the amount involved is imposed on the self-dealer. If the foundation manager is knowingly involved in the self-dealing, a tax of 2½ percent initially is imposed upon him (subject to a maximum of $10,000). Where the foundation manager refuses to agree to the correction of the initial transaction, a tax of 50 percent of the amount involved is imposed. In the case of repeated or willful violations, the tax imposed on the self-dealer or foundation managers may be doubled. A third level of tax may also be assessed as described below in "Change of Status." The Finance Committee provided that the tax on a foundation manager who "knowingly" participates in the self-dealing will not apply unless the violation is willful and is not due to reasonable cause. In addition, the burden of proof that a violation is knowing in such a case is to be upon the Internal Revenue Service to the same extent as in the case of civil fraud under present law.

Both the House and the Finance Committee version of the bill require that the foundation's governing instrument prohibit it from engaging in self-dealing transactions described in the Code.

The Finance Committee added an amendment to the House bill providing for abatement of the additional (second level) self-dealing taxes on private foundations if the State Attorney General takes action to assure that the assets of the private foundation are to be devoted to charitable purposes and the Treasury Department finds that the action of the State Attorney General corrects the violation and generally satisfies the requirements of the bill.

A disqualified person for purposes of the self-dealing provisions (and the other provisions which follow) includes substantial contributors, foundation managers, the families of either of the foregoing, businesses controlled by any of the above, and, for "self-dealing" purposes only, government officials at policymaking levels. The Finance Committee

modified the House definition of "family" in determining who is a "disqualified person" by excluding brothers and sisters (and their descendants). It also excludes from the definition of a disqualified person general partners of substantial contributors where the partner's interest in the partnership is less than 20 percent.

A "substantial contributor" as defined by the Finance Committee amendments is an individual, corporation, or other entity that has in total contributed to a foundation more than 2 percent of the contributions made up to any given time, but in no event less than $5,000. (Contributions for this purpose would be valued at fair market value at the time of the contribution.) In the case of existing foundations, the calculations would be made as though all contributions made before October 9, 1969, were made as of that time. (A husband and wife are to be treated as one for purposes of these calculations.) Once a person becomes a substantial contributor he remains in that status even though he makes no further contributions.

4. Distributions of Income

Present law.—A private foundation loses its exemption if its aggregate accumulated income is unreasonable in amount or duration for its charitable purposes.

Problem.—Under present law, if a private foundation invests in assets that produce no current income, then it need make no distributions for charitable purposes, even though the donor has received full deductions for the value of the nonincome-producing property he has contributed. Also, current distributions are not required until the accumulated income becomes "unreasonable". Finally, the sanctions under present law (as described above under "self-dealing") tend to be either largely ineffective or else unduly harsh.

Finance Committee decision.—The Finance Committee amendments, like the House bill, provide that a private foundation must distribute all of its income currently and further provide that in no event may it distribute less than 5 percent of the value of its assets (other than those assets currently being used in the active conduct of the foundation's exempt activities). Operating foundations are governed by separate expenditure requirements and do not have to meet those imposed by this section.

An extended transition rule is provided before the 5-percent minimum payout rule goes into effect for existing foundations. First, under both the House bill and the Finance Committee amendments, the 5-percent minimum payout requirement does not apply for 1970 and 1971 (although during these two years a foundation is still required to pay out any income actually received). In addition, the Finance Committee amendments provide that in 1972 the minimum payout requirement is to be 3½ percent, 4 percent in 1973, 4½ percent in 1974, and 5 percent in 1975 and subsequent years. Under both the House bill and the committee's amendments, the 5-percent payout is not a fixed figure but is an indication of the amount which the House and the Finance Committee believed should be paid out, given present money rates and stock yields. Should these rates and yields change, the Secretary of the Treasury is authorized to modify the 5 percent payout (either upward or downward) to take into account such changes.

Under both the House bill and Finance Committee amendments, graduated sanctions are imposed in the event of a failure to make timely distributions. Under the House bill and the committee's amendments, a tax of 15 percent of the undistributed amount is imposed where there has been a failure to distribute by the end of the taxable year after the income was earned (unless one of the exceptions described below applies). If the distribution of the remaining amount is not made during the "correction period," then a tax of 100 percent of the amount which should be distributed is imposed.

Both the Committee and the House provisions permit income to be set aside for later distribution in certain limited circumstances and also to carry forward "excess" distributions from one year to another. Income may be set aside for up to five years if approval is obtained in advance from the Internal Revenue Service, by establishing that such an arrangement is needed in order to better assure that the purpose for which the funds are to be spent will be carried out. This could be true, for example, in the case of grants for continuing research or as a part of a matching grant program.

Qualifying distributions for purposes of this provision include distributions to educational and religious organizations, to public charities, and to private operating foundations. However, except as described below, a distribution to a controlled organization does not qualify even if the donee organization is a public charity, etc. Qualifying distributions also include direct expenditures for charitable purposes by the foundation and expenditures by it for assets to be used for charitable purposes.

The Finance Committee made a series of perfecting amendments in determining what constitute qualifying distributions. They are as follows:

(1) The committee's amendments allow foundations to make deficiency distributions (along the lines of the deficiency dividend procedure at present followed by personal holding companies) if failure to distribute is because of failure to properly value the assets and is not willful but is due to reasonable cause.

(2) The committee amendments treat as a qualifying distribution a distribution by one private foundation to another private foundation or to a controlled organization which is exempt under section 501(c)(3) (including either private foundations or private operating foundations) but only if the funds are spent or used by that foundation or controlled organization for charitable purposes within one year of their receipt. This expenditure by the receiving organization is in addition to minimum expenditure requirements otherwise applicable to it. Moreover, the donee organization is not to be permitted to pass the grant through to another private nonoperating foundation or to a controlled organization.

(3) In determining the income which must be distributed currently, the Finance Committee allows as deductions both the audit-fee tax and any tax on unrelated business income. In addition, the committee made it clear that reasonable administrative expenses in operating a private foundation are also to be treated as qualifying distributions.

(4) Under the House bill, a distribution is not a qualifying distribution if made to a controlled organization even though the controlled

organization is an operating foundation (point No. 2 above, however, would modify this in the case of distributions passed on through such organizations within one year). The committee made it clear that an organization is to be considered as "controlled" when persons who are "disqualified persons" with respect to the granting foundation may, by aggregating their votes or positions of authority, require the organization to make a distribution, or prevent the organization from making a distribution.

(5) Loans to individuals which are related to the exempt purpose for which the organization was established—for example, student loans—have generally been considered as qualified distributions at the time of the loan. The committee decided that this was appropriate and that the loans when repaid (or receipts from the sale of assets previously used for charitable purposes) should be treated as income for purposes of the minimum distribution requirement, to the extent the foundation has previously treated the amounts as expenditures which are qualifying distributions. This rule also applies where it is determined that an amount previously set aside (and treated as a qualifying distribution at that time) is no longer needed for the purpose for which it was set aside.

(6) The committee agreed that where written commitments have been made before October 9, 1969, by one private foundation to a second private foundation (even though the second foundation is not an operating foundation), the grants made under such commitments by the end of 1974, are to be treated as grants to an operating foundation (and therefore allowed as qualifying distributions and not subject to the expenditure responsibility limits described below in *Limitations as to Activities of Foundations*) if the foundation to which the distributions are made is not controlled by the granting foundation. However, for the grant to be so treated, it must be made for the charitable, educational, or other purpose or function constituting the basis for the organization's exemption. This is a transition rule intended to provide for already outstanding commitments.

5. Stock Ownership Limitation

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.

Problem.—The use of foundations to maintain control of businesses appears to be increasing. Whether or not the foundation management is independent of donor control, incentive to control a business enterprise frequently detracts from incentive to produce and use funds for charitable purposes. Temptations are frequently difficult to measure and sanctions presently are applied only in rare cases.

Finance Committee decision.—Both the House bill and the Finance Committee's amendments as a general rule limit to 20 percent the combined ownership of a corporation's voting stock which may be held by a foundation and all disqualified persons. However, 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 under both the House bill and the committee's amendments generally must be disposed of within five years.

In the case of existing holdings, the Finance Committee provided that the combined holdings of a private foundation and all disqualified persons in any one business (if at present in excess of 50 percent) must generally be reduced to 50 percent by the end of 10 years after the date of enactment of the bill. However, where the combined holdings now exceed 75 percent, an additional 5 years is allowed before the 50-percent limit must be reached. (This test must be met both as to the combined voting power of stock and also as to the combined value of all classes of stock taken together.) Present holdings in excess of 20 percent but less than 50 percent need not be decreased but they are not permitted to be increased. This is a substitute for the House provision which would have required the meeting of the 20 percent limit, or the 35 percent limit, in the case of existing holdings within a period of 10 years. In addition, the House bill would have provided certain interim requirements calling for progressive partial dispositions at the end of two years and at the end of five years. The Finance Committee amendments delete both of these requirements except, with modifications, in the case of excessive land holdings, as described below.

The Finance Committee also adopted an amendment which would apply to future purchases of business holdings by private foundations. If a foundation buys voting stock of a business, such stock will not be treated as permitted holdings if the foundation votes more than half of the shares so purchased. This limitation will not apply to stock acquired by gift or bequest nor to stock presently held by foundations.

The Finance Committee also made it clear that the excess business holdings requirements do not apply to certain types of investments. First, they do not apply in the case of investments which are related to the exempt program of the organization involved. For example, holdings would not be considered as excess business holdings if they are investments in small businesses in central cities, or in corporations to assist in neighborhood renovation, where these are a part of the charitable program of the organization involved. However, in these cases the making of a profit by the foundation could not be one of the major purposes of the investment and the principal purpose of the organization in making the investment would have to be charitable. Second, the Finance Committee made it clear that passive income sources are not required to be disposed of under this provision. For example, the holding of a bond issue would not constitute an excess business holding nor would the holding of the stock of a company which itself derives essentially passive income in the nature of a royalty be treated as a business holding for purposes of the bill.

In cases where a foundation owns stock in a holding company, the foundation is to be treated as owning its proportionate share of the investments and business holdings held by the holding company in addition to any stock it holds separately from the holding company. If this total exceeds the limitation permitted under the bill, then either the holding company must dispose of some of its investments or the foundation would have to dispose of some of its stock in the holding company if sanctions are not to apply.

Under a committee amendment, property acquired by a foundation in the future under the terms of a will executed before October 9, 1969, or under a trust instrument which was irrevocable at all times since

October 9, 1969, is to be treated under the same rules as property now held by the foundation. In such cases, however, the 10- or 15-year periods are to run from the date the foundation obtains the stock from the trust or the estate.

Both the House bill and the Finance Committee's amendments permit sales of excess business holdings at a fair price to be made by the foundation to disqualified persons (for example, the stock can be redeemed by the corporation issuing it). The Finance Committee amendments also provide that the redemption of stock by a closely held corporation from a foundation to comply with these provisions is not to result in the imposition of the accumulated earnings tax with respect to that corporation, nor is it to give rise to dividend treatment to the foundation or to other shareholders of the corporation. These rules apply only in the case of stock already held by a foundation or acquired by it under existing wills or trusts.

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 all the holding company's voting 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 owns more than 10 percent of the land area of any major political subdivision in in the United States (any county, or a city with a population of more than 100,000) and a foundation and disqualified persons together have excess holdings of 75 percent or more of the stock of such a corporation, 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.

6. Limitations on Use of Assets

Present law.—A private foundation loses its exemption if its accumulated income is invested in such a manner as to jeopardize the carrying out of charitable purposes. No similar specific limitations apply to investment of assets.

Problem.—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 entire corpus of the foundation without being subject to any sanctions. (In one case a court held that a consistent practice of such investments constituted an operation of the foundation for a substantial non-exempt purpose, but the only sanction was loss of tax exemption, which did not really improve the status of charity.)

Finance Committee decision.—Both the House bill and the Finance Committee amendments impose upon all assets of a foundation the same limitations presently applicable only to accumulated income. As a result, under this provision, a foundation must not invest its corpus in a manner which would jeopardize the carrying out of its exempt purposes.

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 so invested. The Finance Committee amendments provide 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 modify the second level sanction, where the jeopardy situation is not corrected, by providing a 25 percent tax 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 also 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.

The committee's amendments make 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 unavilable—is to be considered as a charitable expenditure and not as an investment which might jeopardize the foundation's carrying out of its exempt purposes. To qualify as a program-related investment, the investment must be primarily for charitable purposes and not have as one of its major purposes that of deriving a profit for the foundation.

The committee also decided to make 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.

7. Limitations as to Activities of Foundations

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

Problem.—Under the present law's substantial lobbying provision, a large organization may safely engage in far more lobbying than a small organization. Also, many organizations make their views clear as to which candidates for public office ought to be supported, with confidence that the drastic remedy of loss of exemption will not be imposed. Heavily endowed organizations may engage in lobbying or electioneering and, if exempt status is lost, may continue to avoid tax on investment income by becoming exempt under other provisions of the law. The individual grant device is increasingly being used as a method for funding certain political viewpoints. Organizations that have been called to task for engaging in such activities have claimed that they have no responsibility for how their money is used once a grant has been made.

Finance Committee decision.—Both the House bill and the Finance Committee amendments provide sanctions where private foundations spend money on certain activities, primarily lobbying and electioneering. The definitions in the Finance Committee amendments as to lobbying, however, are somewhat less stringent. First, the House bill prohibits expenditures representing attempts to influence legislation through attempts to affect the opinion of the general public. The committee amendment taxes expenditures where attempts are made to influence legislation by attempting to cause members of the general public to propose, support, or oppose legislation. This is not intended to prevent the examination of broad problems of the type the

government could be expected to deal with ultimately, but it would not permit lobbying on matters which have been proposed for legislative action.

Second, the House bill would tax attempts to influence legislation through private communications with persons who participate in the formulation of legislation, other than through making available the results of nonpartisan analysis or research (except that private foundations could communicate with respect to their own tax status). The committee amendment would tax attempts to influence legislation through communications with government personnel who may participate in the formulation of legislation, except in the case of technical advice or assistance provided to a governmental body in response to a written request by such body or person. In addition, an exception is provided where the activity consists of making available the results of nonpartisan analysis, study, or research (an exception is also provided for communications with respect to the tax-exempt status of the foundation itself).

The committee indicated that where noncommercial educational television and radio stations adhere to the FCC regulations and the "fairness doctrine" (requiring balanced, fair, and objective presentations of issues, and forbidding editorializing), this is to constitute compliance with the first of the two rules specified above. Under this rule, a private foundation would be able to make grants to these television and radio stations without sanctions being applied under this provision, such grants to be tested under the "fairness doctrine" on a grant-by-grant basis.

The House bill provided that voter registration drives would be permitted under this provision 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 Finance Committee decided to delete the portion of the bill which would permit private foundation funds to be used for voter registration drives.

The House bill also prohibits expenditures to influence the outcome of any public election. The committee modified this to prohibit expenditures for the purpose of influencing the outcome of any specific election, because it is arguable that almost any statement or study or general educational activity may become at a future date an issue in an election depending upon the desires of the candidates at that time. Limiting this to "specific" elections would still prohibit the preparation of any materials that were designed to favor or hinder any particular candidate for public office or any particular viewpoint in the case of a referendum.

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 programmatic basis, in accordance with procedures approved in advance by the Internal Revenue Service. Grants may also be made in the form of scholarships or fellowships for specific purposes. Among the permitted purposes for which grants may be made where approval of the program has been obtained in advance are grants for the improvement or enhancement of "a literary, artistic, musical, scientific or other similar capacity, skill or talent." The committee amendments

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also permit individual grants for the enhancement or improvement of "teaching skills." In addition, the committee amendments provide that private foundations may make grants to individuals in the form of prizes or awards if the individuals are selected from the general public on the basis of merit or unusual achievement.

Grants to organizations other than public charities are also prohibited under this provision unless the granting organization becomes responsible for how the money is spent and for providing information to the Internal Revenue Service regarding the 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. For example, if the organization to whom the grant was made supplied a certified audit as to the purpose of the expenditures, this would appear to meet this requirement.

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 the 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 (to a maximum of $10,000) would apply later only if he refused to agree to the correction.

8. Disclosure and Publicity Requirements

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 sheets, and the total amount of contributions and gifts received by it during the year. This requirement applies only to exempt organizations other than: religious organizations (and certain of their affiliates); schools and colleges; publicly supported charitable organizations; certain fraternal beneficial societies; and federally owned, congressionally chartered exempt organizations. These information returns are in addition to the unrelated business income tax 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 may apply in extreme cases.

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

Problem.—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 Fi-

nance 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.

Finance Committee decision.—The House bill makes several changes in the present provisions.

First, the House bill provides that every exempt organization, whether or not a private foundation, must file an annual information return except where the Treasury Department determines that this is unnecessary for efficient tax administration. The Finance Committee provided two exceptions to this provision. First, it exempted churches and their integrated auxiliary organizations and associations or conventions of churches from the requirement of filing this annual information return (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). The integrated auxiliary organizations to which this applies include the church's religious school, youth group, and men's and women's clubs. The committee also exempted from the requirement for 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 can exempt other types of organizations (such as religious orders) from the filing requirements if it concludes that the information is not of significant value.

A second change in present law made by the House bill is to require that there be shown on each information return the names and addresses of all substantial contributors, directors, trustees, and other management officials (all of whom are "disqualified persons" for purposes of several of the new provisions), and of highly compensated employees. Compensation and other payments to managers and highly compensated employees also must be shown. The Finance 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).

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 of $10 per day, up to a maximum of $5,000 as to any one return, imposed upon the foundation. 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 sanction 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 any refusal by the Service to recognize the exempt status of an organization previously exempt or that in the future applies for exempt status, any violation by an organization of the requirements of its exemption, and any mailing of a notice of deficiency regarding any of the new taxes imposed by this bill with respect to private founda-

tions. In addition, the Service is to make available information about the items previously referred to that are relevant to any determination under State law.

9. Change of Status

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.

Problem.—The House and the Finance Committee believe that the Internal Revenue Service has been handicapped in evaluating and administering existing law 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).

Finance Committee decision.—With respect to the first problem outlined above, the House bill provided that new exempt organizations must notify the Internal Revenue Service if they claim exempt status under section 501(c)(3). It also required that they, and existing organizations, notify the Service if they claim to be other than private foundations. The 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 Finance Committee concluded that churches, their integrated auxiliaries, and conventions or associations of churches, whether or not the Treasury acts, should not be required to claim 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 those 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 (such as religious orders) where this is consistent with efficient administration.

With respect to the second problem outlined above, the House bill provides that an organization which was a private foundation for its last taxable year ending before May 27, 1969, or become one on a

subsequent date, may not change its status unless it repays to the government the aggregate tax benefits (with interest) which have resulted from its exempt status. (This tax may be abated, however, as described below.) 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 these cases are the increases in income, estate, and gift taxes which would have been imposed upon the organization and all substantial contributors if the organization had been liable for income taxes and if its contributors had not received deductions for contributions to the organization.

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 organizations which have been public charities, or (2) itself has operated as an organization which is not a private foundation for at least five years.

The Finance Committee accepted the House provision described above except that it provided that where a private foundation volunteers to change its status by acting in 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. 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. However, it would during the 5-year period continue to be treated as the same private foundation subject to the same change of status rules if it engages in willful, flagrant, or repeated violations. Also, if an organization that was a private foundation for its last taxable year ending before October 9, 1969, changes into a "public" charity in its first taxable year beginning after December 31, 1969, it need not go through the processes required by this "Change of Status" provision.

The committee's amendments provide that the tax on change of status, discussed above, may also be abated if the Service is satisfied that corrective action to preserve the foundation's assets for charity has been completed by the State Attorney General or other appropriate State official under the supervision of the appropriate courts.

10. Definition of Private Foundation

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. Deductions of up to 30 percent of a donor's income may be taken for contributions to (1) churches, (2) schools, (3) hospitals, (4) fund-raisers for schools, (5) States and subdivisions, and (6) publicly supported charities.

Problem.—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 organizations presently in the 20-percent group. However, it appears that certain 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.

Finance Committee decision.—The House bill provides that private foundations subject to the provisions described in the first 9 parts of

this summary are organizations referred to in section 501(c)(3) of the code *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 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 investment income, if at least one-third of its support comes from the public (in the form of gifts, grants, contributions, membership fees, and gross receipts from admissions) 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 but no more than one-third of its support may come from investment income.

The committee in general accepted this definition 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.

(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 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.

(c) The committee provided that an organization which would meet all of the tests of the third category described above except that it is operated in connection with two or more specific schools nevertheless may qualify where all the beneficiaries are educational organizations.

(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. A gift by a domestic private foundation to a foreign nonoperating private foundation generally will not be a qualifying distribution; a gift to a foreign operating foundation will qualify under the same circumstances that a gift to a domestic operating foundation would qualify.[1]

(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.

11. Private Operating Foundation Definition

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 purposes or function.

Problem.—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 the committee amendments, charitable contribution donations to operating foundations are eligible for the 50-percent charitable contribution deduction. Fourth, while operating foundations are required to spend or use "substantially all

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[1] 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. The audit-fee tax will be 2 percent of the gross 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 normal support (other than investment income) comes from the United States. However, in general, such a foreign private foundation loses 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 had it been a domestic organization engaging in those same acts. Also, no income, gift, or estate tax deductions would be allowed to an organization that has lost its exempt status under these circumstances. In effect, such an organization would be treated as a taxable nonresident alien.

of their income" for their educational or charitable purposes, they are not subject to the 5-percent minimum payout requirement nor required to expend their entire income.

Finance Committee decision.—The House bill and the committee amendments provide that an operating foundation is a private foundation substantially all 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 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 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. 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.)

12. Hospitals

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

Problem.—It has been contended by some revenue agents that hospitals (unlike educational organizations, churches, and others) must provide some significant amount of charitable services without charge or below cost in order to be exempt as "charitable" organizations.

The Internal Revenue Service has issued a ruling 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.

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

13. Effective Dates

The provisions described above generally apply to taxable years beginning after December 31, 1969.

Finance Committee decision.—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. The committee also agreed that this 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.

B. OTHER TAX-EXEMPT ORGANIZATIONS

1. The "Clay Brown" Provision or Debt-Financed Property

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. Nor does the tax apply to income from the leasing by a tax-exempt organization of assets constituting a going business.

Problem.—During the past several years weaknesses in the present provision relating to debt-financed property have been exploited in several different respects. As a result a large number of tax-exempt organizations have used their tax-exempt privileges to buy businesses and investments on credit, frequently at what is more than the market price, while contributing little or nothing themselves to the transaction other than their tax exemption.

In a typical *Clay Brown* situation a corporate business is sold to a charitable or educational foundation, which makes a small or no down payment and agrees to pay the balance of the purchase price out of profits from the property. The charitable or educational foundation liquidates the corporation, leases the business assets back to the seller, who forms a new corporation to operate the business. The newly formed corporation pays a large portion of its business profits as "rent" to the foundation, which then pays most of these receipts back to the original owner as installment payments on the initial purchase price.

In this manner in the *Clay Brown* case (1965 Supreme Court case), a business was able to realize increased after-tax income, and the exempt organization acquired the ownership of a business valued at $1.3 million, without the investment of its own funds. In the recent (1969) *University Hill Foundation* case, the Tax Court upheld the

acquisition of 24 businesses by the University Hill Foundation in the period 1945 to 1954. Other variants of the debt-financed property problem have also been used.

Finance Committee decision.—Both the House bill and the committee amendments provide that all exempt organizations' income from "debt-financed" property, which is unrelated to their charitable 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. The provision makes exceptions for property to be used for an exempt purpose of the organization involved within a reasonable time and also for property acquired by gift or inheritance under certain conditions. 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 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.

The Finance Committee and House versions of the bill are the same except for the following modifications:

(1) It is to be made clear in the committee report that property acquired under life income contracts is not to be treated as debt-financed property except where payments received by any of the life beneficiaries are treated for tax purposes as the proceeds of a sale.

(2) Where a debt-financed building is operated by an exempt holding company (or other exempt organization) for the benefit of an affiliated exempt organization, the committee amendments specify that 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.

(3) The House bill exempts from the classification of debt-financed property, property where "all" of the property is used for the exempt purpose of the organization. The committee amendments specify that this exclusion also is to include cases where "substantially all" of the property is used for the organization's exempt purposes. In addition, if less than substantially all of the property's use is related to the exempt purpose of the organization, to the extent that the property is so used it is not to be considered as debt-financed property.

(4) Generally, an acquisition indebtedness would exist with respect to any property whenever the indebtedness was incurred in acquiring or improving the property or would not have been incurred "but for" the acquisition or improvement of the property. Thus, for example, where a church has a portfolio of investment with no debt, and subsequently acquires 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.

2. Extension of Unrelated Business Income Tax to All Exempt Organizations

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.

Problem.—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. Some churches, for example, 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 taxing a country club or lodge engaged in similar activities.

Finance Committee decision.—The House bill and the Finance Committee amendments extend the unrelated business income tax to all exempt organizations (except United States instrumentalities). The organizations which will newly be made subject to this tax include churches and conventions or associations of churches, social welfare organizations, social clubs, fraternal beneficiary societies, employees' beneficiary associations, teachers' retirement fund 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 contains several administrative provisions including one providing that no audit of a church, its integrated auxiliaries, or 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. Churches will not be subject to tax for 6 years on businesses they now own.

The Finance Committee amendments differ from the House provisions only in the following respects:

(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 modify this to limit the exclusion for rents of

personal property to cases where the personal property is incidental to the lease of the real property. Further, in any case, rents from real property would be taxed where such property is leased with personal property, if 50 percent or more of the rent is attributable to the personal property. In addition, the committee amendments tax as unrelated business income property rentals of both real and personal property where the rentals are measured by reference to the net income from the property.

(2) The committee amendments will make it clear that related income includes income received from members for providing goods, facilities, or services not only to guests but also to members' dependents.

(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, to the extent that each such local unit has such income.

(4) Under present law, a voluntary employees' beneficiary association (exempt under sec. 501(c)(9)) 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, the 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 where the members are United States Government employees (sec. 501(c)(10)). For this reason, 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, will 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.

(5) In defining what constitutes related business income, the committee amendments provide that when an exempt holding company and a tax-exempt organization to which it is related file a consolidated return, the holding company is to be treated as organized and operated for the same purposes as the exempt organization. This means that the income of the holding company will be classified as related business income if it is related to the exempt functions of the exempt organization.

(6) In the case of churches, it will be made clear in the committee report that the term "related business income" includes 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, as long as these activities are carried on in connection with the church.

(7) The committee amendments provide that the unrelated business income tax is ~~not to~~ apply to a religious order or to an educational institution maintained by such religious order that has held unrelated businesses, which provide services under licenses issued by a Federal

regulatory agency, for 10 years or more, if the unrelated business distributes not less than 90 percent of its earnings each year 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.

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

(9) 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. These exceptions do not apply, however, unless the business is run for the benefit of a single exempt organization. The committee amendments extend these exceptions to cases where such a business is run for the benefit of more than one exempt organization and also where it is run as a separate corporation.

3. Taxation of Investment Income of Social, Fraternal, and Similar Organizations

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

Problem.—Since the tax exemption for social clubs and other groups is designed, at least in part, to allow individuals to join together to provide recreational or social facilities without tax consequences, the tax exemption operates properly only where the sources of income of the organization are limited to receipts from the membership. Where an organization receives income from sources outside the membership, such as income from investments, upon which no tax is paid, the membership receives a benefit from the tax-exempt funds used to provide pleasure or recreational facilities.

Finance Committee decision.—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. This does not apply under the House bill, however, to the income of fraternal beneficiary associations and employees' beneficiary associations to the extent the income is set aside to be used only for the exempt insurance function of these organizations or for charitable purposes. If in any year, an amount is taken out of the set-aside and used for any other purpose, however, this amount will be subject to tax at that time.

The Finance Committee amendments modify the House bill by excluding fraternal beneficiary associations from the tax on investment income. In addition, a new category of exemption for fraternal beneficiary associations is set forth which applies to fraternal organizations operating under the lodge system (such as the Masons) where the fraternal activities are largely religious, charitable or educational in nature but where no insurance is provided for the members.

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 set aside for charitable purposes to the other types of organizations to which the investment income tax is to apply. In doing so, it intends in the case of national organizations of college fraternities and sororities that amounts set aside for scholarships, for student loans or 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 amendments also provide that amounts set aside for the reasonable cost of administration of benefit programs, as well as the payment of benefits themselves, constitutes use for educational, charitable, etc. purposes.

In addition, the committee amendments provide 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 one year before the date of sale and ending three years after that date.

4. Interest, Rent, and Royalties From Controlled Corporations

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.

Problem.—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.

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

The committee amendments modify this provision by providing that where the subsidiary is also an exempt organization it is to apply only to the extent the income is unrelated business income to the subsidiary. As a result, the payments received from the subsidiary would not be subject to tax to the extent the facilities rented or the money borrowed is used by the exempt organization in the performance of its exempt function. Where the operation of the controlled corporation is "functionally related" to the exempt purposes of the controlling exempt organization, these types of income from the taxable subsidiary would be "related" income and would not be subject to tax.

5. Limitation on Deductions of Nonexempt Membership Organizations

Present law.—Some courts have held that taxable membership organizations cannot create a "loss" by supplying their members services at less than cost so that the resulting loss on membership activities reduces income earned from investments or other activities. Other courts have held instead that such a "loss" is permissible, that the expenses of providing such services at less than cost will offset from taxation additional income earned by the organization from investments or other activities.

Problem.—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 the courts 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.

Finance Committee decision.—The House bill provides 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 was 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 Finance Committee amendments accept this provision in general but provide the following modifications:

(1) The provision is not to apply in certain situations where there is no attempt to subsidize services to members with income from nonmembership sources, such as in the case of the American Automobile Association which receives prepaid dues income as consideration for services to be rendered in competition with the charges made by other automobile clubs which are operated as loss leaders for profit organizations.

(2) The provision is not to apply to securities and commodities exchanges organized on a membership basis.

(3) 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.

(4) The committee amendments postponed the effective date of this provision for one year or until 1971. In addition, the committee report is to make it clear that the adoption of this provision is not to be taken as any inference as to the allowability of a deduction for the excess of such costs over income from members under existing law.

6. Income From Advertising, Etc.

Present law.—Late in 1967 the Treasury promulgated regulations under which the income from advertising was treated as "unrelated business income" even though such advertising appeared, for example, in a periodical related to the educational or other exempt purpose of the organization.

Problem.—While it was concluded that the regulations reached an appropriate result in specifying that in carrying on an advertising business in competition with other taxpaying advertising businesses a tax should be paid, nevertheless, the statutory language on which the regulations were based was sufficiently unclear so that substantial litigation could have resulted from these regulations.

Finance Committee decision.—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 Finance Committee amendments approve the intent of the House provision but provide for a restructuring of the language so that it will have application only in the areas to which the regulations had application; 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. 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."

C. CHARITABLE CONTRIBUTIONS

1. 50 Percent Charitable Contribution Deduction

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

Problem.—It has been suggested that it would be desirable to strengthen the incentive for charitable giving by increasing the present 30 percent limitation on the charitable contribution deduction. Moreover, it was hoped that an increase would offset any decreased incentive resulting from the repeal of the unlimited charitable contributions deduction (see No. 2 below).

Finance Committee decision.—The House bill increases the general 30 percent limitation on an individual's charitable contribution deductions to 50 percent. The 20 percent charitable contribution deduction limitation is retained in the case of gifts to private foundations. Also contributions of appreciated property continue to be subject to the present 30 percent limitation.

The Finance Committee amendments, while retaining the general House rules, modify them in two respects. First, they provide that private operating foundations, and also private nonoperating foundations, which within one year distribute the contributions they receive to religious, educational, or public charities, or private operating foundations, are to qualify for the 50 percent limitation in the same

manner as other contributions. Second, the committee amendments provide that the 30 percent limit is to apply only to the appreciation portion of the value of a gift of appreciated capital gain property (to which the separate appreciated property rules do not apply). Thus, the basis portion of the value of the property would be eligible for the 50 percent limit before applying the 30 percent limit to the appreciation portion.

The House bill provides that the contribution base to which the percentage limitation is to be applied is adjusted gross income plus the amount of tax preferences not included in the tax base. The committee amendments restore existing law which bases the percentage upon adjusted gross income.

2. Repeal of the Unlimited Charitable Deduction

Present law.—The charitable contributions deduction for individuals generally is limited to 30 percent of the taxpayer's adjusted gross income. An exception to the 30 percent general limitation allows a taxpayer an unlimited charitable contributions deduction, if in 8 out of the 10 preceding taxable years the total of the taxpayer's charitable contributions plus income taxes paid exceeded 90 percent of his taxable income.

Problem.—It has been pointed out that the unlimited charitable contributions deduction has permitted a number of high-income persons to pay little or no tax on their income. It appears that the charitable contributions deduction is one of the two most important itemized deductions used by high-income persons, who pay little or no income tax, to reduce their tax liability.

Finance Committee decision.—The unlimited charitable contribution deduction under both the House bill and committee amendments is to be eliminated for years beginning after 1974. During the interim period, an increasing limitation is to be placed on the amount by which the deduction may reduce the individual's taxable income. For taxable years beginning in 1970, the total charitable deduction (for those qualifying under this provision) is not to be allowed to reduce an individual's taxable income to less than 20 percent of his adjusted gross income. This percentage is increased by six percentage points a year for the years 1971 through 1974. 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 during this interim period is reduced to 80 percent in 1970, and then is reduced by six percentage points a year for each of the years 1971 through 1974.

The committee amendments, while in accord with the rules set forth above, specify that during the interim period through 1974 the 30 percent limit on gifts of appreciated property and the appreciated property rule which in some cases takes the appreciation into account for tax purposes are not to apply in the case of a person qualifying for the extra charitable contribution deduction in the interim period in the case of property which would give rise to a long-term capital gain if sold.

3. Charitable Contributions of Appreciated Property

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 at

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the time of contribution. Further, no income tax is imposed on the appreciation in value of the property at the time of the gift. In addition, 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).

Problem.—The combined effect of not taxing the appreciation in value and at the same time allowing a charitable contributions deduction for the fair market value of the property given 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 long-term capital assets is the capital gains tax which would have been paid if the asset were sold. In the case of ordinary income type assets, however, this tax saving is at the taxpayer's top marginal tax rate. In either case, the tax saving from not taxing the appreciation in value is combined with the tax saving of the charitable deduction at the taxpayer's top marginal rate. As a result, in some cases it 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.

Finance Committee decision.—The House bill, in the case of charitable contributions of appreciated property, takes this 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 Finance Committee amendments provide that appreciation is to be taken into account for tax purposes 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 into account appreciation in value in the case of property (such as inventory or works of the donor) which would give rise to ordinary income if sold.

In the cases 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 one-half 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.

The House bill would also have taken appreciation in value into account in the case of gifts of tangible personal property (such as paintings, art objects and books not created by the donor) and in the case of future interests in property. The Finance Committee amendments do

not include these two provisions. In addition, in the case of so-called bargain sales to charities—where a taxpayer sells property to a charitable organization for less than its fair market value (usually at its cost basis)—the House bill provided that the cost or other basis of the property was to be allocated between the portion of the property "sold" and the portion of the property "given" to the charity on the basis of the fair market value of each portion. This provision is deleted by the committee amendments.

The committee amendments are generally effective for contributions paid after December 31, 1969 (as under the House bill). However, in the case of a contribution of a letter or memorandum, or similar property, the committee's amendments apply to such contributions paid after December 31, 1968.

4. Two-Year Charitable Trust

Present law.—Under present law, an individual may establish a trust for two years or more with the income from property placed in the trust being payable to charity. In such a case, although the trust instrument provides that after the designated period of time the property is to be returned to him, the income from the trust property is not taxed to the individual. However, the individual does not receive a charitable contributions deduction in such a case.

Problem.—The special two-year charitable trust rule has the effect of permitting charitable contributions deductions in excess of the generally applicable percentage limitations on such deductions. For example, with the 50 percent limitation on such deductions contained in 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 60 percent of his stock to a trust with directions to pay the annual income ($60,000) to charity for two years and then return the property to him, the taxpayer would exclude the $60,000 from his own income each year. In effect, then, the individual has received a charitable contributions deduction equal to 60 percent of his income.

Finance Committee decision.—Both the House bill and the committee amendments eliminate the rule under which an individual is not taxed on the income from property which he transfers to a trust to pay the income to charity for a period of at least two years. This provision applies to transfers after April 22, 1969. As a result, a person who establishes a trust with charity as the income beneficiary will be taxable on the income where he retains a reversionary interest which may be expected to take effect within ten years from the time the trust is created.

5. Gifts of the Use of Property

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.

Problem.—By giving a charity the right to use property which he owns for a given period of time a taxpayer achieves a double benefit. For example, if an individual owns an office building, he may donate

the use of 10 percent of its rental space to a charity for one year. He then reports for tax purposes only 90 percent of the income which he would otherwise have been required to report if the building were fully rented, and he claims a charitable deduction (equal to 10 percent of the rental value of the building) which offsets his already reduced rental income.

Finance Committee decision.—The House bill generally provides that the charitable deduction is not to be allowed for contributions to charities of less than a 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 would be allowed where a contribution is made of the right to use property for a period of time. In such a case, however, a taxpayer is able to continue to exclude from his income the value of the right to use property so contributed.

The Finance Committee retains the basic provision but modifies it so that it will not result in the denial of a deduction for an outright gift of a fractional (e.g. one-fourth) interest in the entire property. This is accomplished by limiting the application of the rule subjecting outright gifts to the treatment accorded gifts in trust to charitable contributions of either (a) a terminable interest in property (e.g. the use of property for a period of years), (b) the income from property for a period of years), or (c) a future interest in property.

6. Charitable Contributions by, and Stock Holdings of, Estates and Trusts

Present law.—Present law allows a nonexempt trust (or estate) a full deduction for any amount of gross income which it permanently sets aside for charitable purposes. There is no limitation on the amount of this deduction. Also, there are no limitations on the proportions of the stock of a company which may be held by a nonexempt trust or estate.

Problem.—To retain the deduction allowed by present law for nonexempt trusts for amounts set aside for charity (rather than paid to charity) would appear inconsistent with the requirements in the bill requiring foundations and charitable trusts to distribute all of their income. Not to subject these trusts generally to the same requirements and restrictions as those imposed on private foundations would present an easy means of avoiding these restrictions by setting amounts aside for charity in nonexempt trusts but not distributing these amounts for extended periods of time. Problems also arise as to the extent it is appropriate to apply the stock diversification requirements of foundations to the nonexempt trusts.

Finance Committee decision.—Neither the House bill nor the committee amendments impose the current income distribution requirements, generally applicable to foundations, to nonexempt trusts. Instead, much the same result is achieved by generally denying a deduction to nonexempt trusts for the amount of their current income set aside for charity. In other words, to obtain a deduction for a charitable distribution, a nonexempt trust with charitable income beneficiaries must pay out its income currently to charity, in much the same manner as a private foundation is 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),

both versions of the bill provide that if specified requirements are met the trust is to be tax exempt. The requirements limit the trusts accorded tax-exempt status to annuity trusts (where the noncharitable beneficiary receives a fixed dollar amount each year) and unitrusts (where the noncharitable beneficiary receives a stated percentage of the assets each year). In these cases the value of the income going to the noncharitable beneficiaries is taxed to them currently. The amount going to charity (because of a rule set forth subsequently) is deductible to the donor only to the extent of the remainder interest and not with respect to any income interest.

In the case of estates, the House bill also denied charitable contribution deductions to the estate for income set aside for charity. The committee amendments, however, restore the set-aside deduction for income of estates set aside for charity.

In addition to restoring the set-aside deduction in the case of estates, the Finance Committee amendments restore this deduction in the case of pool arrangements under which a person transfers property to a public charity, which places the property in an investment pool and then pays the donor (or perhaps another person) the income attributable to the property for his life. In such cases, the committee amendments restore the set-aside deduction to the extent that the pool accumulates capital gains for the benefit of charity. These pool arrangements qualify the donor for a charitable contribution deduction.

The committee amendments also restore the set- aside deduction in the case of trusts established before October 9, 1969, with an irrevocable charitable remainder. In addition, the committee amendments restore the set aside deduction for trusts established pursuant to a will in existence on October 9, 1969 which may not be changed under State law prior to the person's death because of his incompetency or other disability. A third transitional category where the committee amendments restore the set aside deduction is where the trust is provided for in a will in existence on October 9, 1969, and the person involved dies within three years of that date.

The committee amendments provide that the elimination of the set-aside deduction except as indicated above is to become effective with respect to taxable years beginning in 1970.

The committee amendments make it clear that the limitations on business holdings and the speculative investment limitations applicable to foundations are not to apply in the case of certain split-interest trusts. Thus they will not apply where charity is the income beneficiary and the value of the income interest does not exceed 60 percent of the value of the trust property. They also will not apply in the case of a charitable remainder trust until such time as the charity comes into the remainder interest if none of the income interest in the trust is held by or for charitable interests. At that time, the 5-year period for stock diversification would be available.

7. Charitable Remainder Trusts

Present law.—Under present law an individual may make an indirect charitable contribution by transferring property to a trust and providing that the trust income is to be paid to private persons for a period of time with the remainder to go to a charity. Generally, a charitable contribution deduction is allowed 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 of 3½ percent.

Problem.—Present rules allow a taxpayer to receive a charitable contribution deduction for a gift to charity of a remainder interest in trust which is substantially in excess of the amount the charity may ultimately receive. This is because the assumptions used in calculating the value of the remainder interest may bear little relation to the actual investment policies of the trust. For example, the trust assets may 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. This factor, however, is not taken into account in computing the amount of the charitable contribution deduction.

Finance Committee decision.—The House bill limits the availability of the charitable contribution deduction for income, estate and gift tax purposes in the case of a charitable gift of a remainder interest in trust to situations where there is a close correlation between the amount to be received by the charity and the amount of the deduction allowed the donor on the creation of the trust. In general a deduction is allowed only where the trust specifies the annual amount which is to be paid to the noncharitable income beneficiary in dollar terms (annuity trust) or as a fixed percentage of the value of the trust's assets as determined each year (unitrust).

The amount of the deduction allowed on the creation of the charitable remainder interest in trust thus would be computed on the basis of the actual relative interests of the noncharitable income and the charitable remainder beneficiaries in the trust property.

The Finance Committee amendments retain the treatment described above with the following modifications:

(1) Where a person transfers property to a charity which places the property in a pool or fund and then pays a share of the pool's income to the person for his life, the life of his spouse or that of another person, a charitable contribution deduction would be allowed to the donor determined by reference to the highest rate of return from the particular pool or fund in which the investment is placed during the three years prior to the contribution.

(2) The committee amendments make the new rules inapplicable in the case of a gift of real property to charity where the donor (and/or his spouse) reserves the right to live on, or receive the income from, the property for his (or their) life. In determining the value of the gift in such a case, straight line depreciation or cost depletion is to be taken into account with respect to the property. In addition, the rate of return based on today's money rates and stock returns should be computed on a 6 percent basis with the Secretary of the Treasury varying this amount as money rates and investment returns change.

(3) The committee amendments modify the unitrust and annuity trust rules of the House bill by providing that the trust instrument need not require the full distribution of the stated amount (i.e., the unitrust percentage amount or the annuity amount) to the income beneficiary so long as a distribution of the full current income (other than capital gains) is required. For this purpose, distributions of income in excess of the stated amount could be made to the extent that

distributions of income in earlier years were less than such amount. However, the value of the charitable remainder would be determined by reference to the stated amount. Further, such value would be determined on the basis of a 5 percent payout to the income beneficiary if 5 percent is higher than the stated amount.

(4) The definitions of annuity trust and unitrust are modified under the committee amendments to make it clear that the provision may apply to trusts with more than one noncharitable income beneficiary (either concurrently or successively).

(5) The charitable remainder trust rules under the committee amendments are to be effective only in the case of transfers in trust after October 9, 1969.

(6) The committee amendments make the charitable remainder trust requirements inapplicable for estate tax purposes in the case of trusts created before October 9, 1969, with an irrevocable charitable remainder.

(7) The committee amendments make the charitable remainder trust rules inapplicable for estate tax purposes with respect to wills in existence on October 9, 1969, if the person involved dies within three years, or if the will could not be changed under State law prior to the person's death because of his incompetency or other disability.

8. Charitable Income Trust With Noncharitable Remainders

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 member of his family, is allowed a charitable contribution deduction for the value of the income interest given to charity. In addition, neither he nor the trust is taxed on the income earned by the trust which is given to charity.

Problem.—A taxpayer receives a double tax benefit where he is allowed a charitable deduction for the value of an income interest in trust given to charity and also is not taxed on the income earned by the trust.

Finance Committee decision.—The House bill and the Finance Committee amendments generally provide that a charitable contribution deduction for income tax purposes is not to be allowed where a person gives an income interest to charity in trust unless he is taxable on the trust income. Moreover, even in this case the charitable deduction will not be allowed unless the charity's income interest is in the form of a guaranteed annuity or is a fixed percentage (payable annually) of the value of the trust property (as determined each year).

Under the House bill, the charitable deduction for gift tax purposes is subject to the above rules. In addition, a charitable deduction for estate tax purposes also is denied for gifts of income interests in trust.

The Finance Committee amendments make the rules described above (other than the requirement that the gift take the form of a guaranteed annuity or fixed percentage payout) inapplicable for gift and estate tax purposes.

The committee amendments make these rules applicable for purposes of income tax charitable deductions to transfers in trust after October 9, 1969.

D. FARM LOSSES

1. Limitation on Deductions Attributable to Farming

Present law.—Under present law, income and losses from farming may be computed under more liberal accounting rules than those generally applicable to other types of businesses. A cash method of accounting under which costs are deducted currently may be used, rather than an accrual method of accounting and inventories under which the deduction of costs would be postponed. In addition, a taxpayer in the business of farming may deduct expenditures for developing business assets (such as raising a breeding herd or developing a fruit orchard) which other taxpayers would have to capitalize. In addition, capital gains treatment quite often is available on the sale of farm assets.

Problem.—Although the special farm accounting rules were adopted to relieve farmers of bookkeeping burdens, these rules have been used by some high-income taxpayers who are not primarily engaged in farming to obtain a tax, but not an economic, loss which is then deducted from their high-bracket, nonfarm income. In addition, when these high-income taxpayers sell their farm investment, they often receive capital gains treatment on the sale. The combination of the current deduction against ordinary income for farm expenses of a capital nature and the capital gains treatment available on the sale of farm assets produces significant tax advantages and tax savings for these high-income taxpayers.

Finance Committee decisions.—The Finance Committee adopted a substitute in lieu of the House provision which provides that farm losses may be offset against nonfarm income only to the extent of 50 percent. The remaining half of the farm deductions may be taken in subsequent years to the extent that ordinary farm income exceeds farm deductions. In the case of individuals the deduction of farm losses against nonfarm income is limited in the manner described above only if the taxpayer has more than $50,000 of nonfarm income for the year and, in addition, only to the extent the farm loss for the year exceeds $25,000.

The current deduction limitation rules described above do not apply if the taxpayer elects to follow generally applicable business accounting rules (i.e., uses inventories and capitalizes capital expenses).

The House provision for which the above is a substitute would, in effect, have converted capital gains into ordinary income to the extent a taxpayer's farm losses (above limitations) had been offset against nonfarm income. Under the House bill a taxpayer would be required to maintain an "excess deductions account" to record his farm losses. In the case of individuals, farm losses would be added to EDA only if the taxpayer had more than $50,000 of nonfarm income for the year and only to the extent the farm loss for the year exceeded $25,000.

The amount of farm losses which would have been recaptured on the sale of farm land would be limited to the deductions in the current and four prior years with respect to amounts spent for soil and water conservation and land clearing. To the extent of the gain on farm property which would be treated under these rules as ordinary income, there would be a reduction in the taxpayer's excess deductions account. As under the Finance Committee substitute, these rules

would have been applicable both to corporations and individuals. Also as under the Finance Committee substitute the recapture rules provided by the House bill would not apply if the taxpayer elected to follow generally applicable business accounting rules.

The Finance Committee substitute and the House provision would apply to farm losses in years beginning after 1969.

2. Depreciation Recapture

Present law.—Present law provides that when a taxpayer sells personal property used in a business, there is a recapture of the depreciation claimed on the property. In other words, the gain on the sale of the property is treated as ordinary income, rather than capital gain, to the extent of the depreciation previously claimed. These rules do not apply, however, to livestock.

Problem.—The effect of the exclusion of livestock from the depreciation recapture rule is to allow a taxpayer to convert ordinary income into capital gain with substantial tax savings. This occurs because the depreciation is deducted currently from ordinary income taxed at the regular rates, but the gain on the sale of the livestock is taxed only at the lower capital gains rates.

Finance Committee decision.—Both the House bill and the Finance Committee amendments eliminate the exception for livestock from the depreciation recapture rules. As a result gain on the sale of livestock is to be treated as ordinary income, rather than as capital gain, to the extent of the previous depreciation deductions.

This provision applies to years after 1969 but only to the extent of depreciation taken after 1969.

3. Holding Period for Livestock

Present law.—Present law allows gain on the sale of livestock held for draft, breeding, or dairy purposes to be treated as a capital gain, if the animal has been held by the taxpayer for one year or more.

Problem.—A one-year holding period allows taxpayers to make short-term, tax-motivated investments in livestock. 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 of raising the animals against his other income which is taxed in the high bracket, and then sell the entire herd at the lower capital gains rates.

Finance Committee decision.—The committee adopted an amendment which provides that in order for any gain upon the sale of horses and cattle to result in capital gain, where the animals are held for draft, dairy, breeding or sporting purposes (such as horse racing), the animals must have been held for at least 2 years. The gain on the sale of other types of livestock held for one of these purposes, however, would continue to be subject to the 1-year holding period presently in existing law.

The House bill provided that livestock, in order to be eligible for capital gains treatment upon sale (in the case of animals held for draft, dairy, breeding or sporting purposes), must have been held by the taxpayer for at least 1 year after the animals would normally have been used for draft, dairy, breeding or sporting purposes.

Both the Finance Committee amendment and the House provision would apply to livestock acquired after 1969.

4. Hobby Losses

Present law.—Present law contains a so-called hobby loss provision which limits to $50,000 per year the amount of losses from a "business" carried on by an individual that he can use to offset his other income. This limitation only applies, however, if the losses from the business exceed $50,000 a year for at least five consecutive years. Moreover, certain specially treated deductions are disregarded in computing the size of the loss for this purpose.

Problem.—This hobby loss provision generally has been of limited application because it usually is possible to break the required string of five loss years. In addition, where the provision has applied to disallow the deduction of a loss, the taxpayer has been faced in one year with a combined additional tax attributable to a five-year period.

Finance Committee decision.—The House bill would replace the present hobby loss provision with a rule which disallows the deduction of losses from an activity carried on by the taxpayer where the activity is not carried on with "a reasonable expectation of profit." An activity would be presumed to have been carried on without this expectation of profit where the losses from the activity were greater than $25,000 in three out of five years.

The Finance Committee amendments make a series of modifications in this provision, as follows:

(1) In lieu of the test of "a reasonable expectation of profit" provided by the House bill, the committee amendments substitute the test of "not engaged in for profit." This differs from the House approach in that there would no longer need to be a reasonable expectation of profit so long as the facts and circumstances (without regard to the taxpayer's subjective intent) indicate that the taxpayer engaged in the activity, or continued the activity, with the objective of making a profit.

(2) In lieu of the presumption in the House provision to the effect that the activity constitutes a hobby, where there are losses of $25,000 or more in three out of five years, the committee amendments substitute a presumption that the taxpayer is not engaged in carrying on the activity as a hobby if he has profits in two out of five years.

(3) The Treasury Department has indicated its willingness to 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 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.

(4) The committee amendments provide that deductions will in no event be disallowed under this provision for items which presently may be deducted without regard to whether the taxpayer incurs them in a trade or business or for the production of income. This is true, for example, in the case of the capital gains deduction and the deduction for interest and certain State and local taxes.

(5) The Finance Committee amendments allow deductions in the case of an activity not engaged in for profit to the extent income is earned from such an activity. A deduction would be allowed for

expenses to the extent they do not exceed the income realized from the activity in question after the deduction of the expenses which are allowed in any event (those referred to in item 4 above).

(6) The committee amendments restrict the applicability of the hobby loss provision to individual taxpayers and subchapter S corporations .

5. Crop Insurance Proceeds

Present Law.—Under present law a cash-basis farmer whose crops have been destroyed and who receives crop insurance proceeds in compensation for his loss reports the proceeds as income in the year received.

Problem.—A problem arises in that the crops which have been destroyed might not, under normal circumstances, have been reported as income until the following year. As a result, the reporting of the insurance proceeds in the earlier year may result in a doubling up of income in that year (since the farmer may in the forepart of that year also be reporting the income from the sale of crops from the prior year). In the next year, since the farmer has only deductions and no income to report, he is likely to have a net operating loss which may be carried back and offset against income in the year in which the double amount was reported. However, the problem which arises is that the farmer in such cases is faced with the advance payment of tax and also may lose the benefit of exemptions and personal deductions in the year of the loss.

Finance Committee decision.—The committee added a new provision to the House bill which provides that, at his election, a cash-basis farmer whose crops have been destroyed and who receives crop insurance proceeds in compensation for his loss may elect to defer the reporting of these proceeds for Federal income tax purposes until the year following the year of destruction if this is the year in which he normally would have reported the income from the sale of the crops had they not been destroyed.

6. Exchange of Livestock of Different Sexes

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.

Problem.—There appears to be some confusion at present as to whether an exchange of male calves for female calves qualifies as a tax-free, like-kind exchange. If this can be done, a breeding herd of females could be built up more quickly without tax consequences. Although the Revenue Service does not consider this to be a like-kind exchange, it has not taken a published position.

Finance Committee decision.—The committee added a new provision to the House bill which provides 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. Although this provision was not included in the House bill, the House Ways and Means Committee in its report on the bill stated that it believed this to be the proper interpretation of present law.

7. Gain From Disposition of Farm Land.

Present Law.—Under present law, a taxpayer may elect to currently deduct expenditures for soil and water conservation purposes and

land clearing expenditures from ordinary income. Under normal accounting rules these expenditures would be added to the basis of the farm property and, thus, would reduce the amount of capital gain realized on the sale of the property.

Problem.—The current deduction allowed for soil and water conservation expenditures and land clearing expenditures with respect to farm land, combined with the capital gains treatment allowed on the sale of the farmland allows high income taxpapers to convert ordinary income into capital gain income. These taxpayers may purchase farm land, deduct these expenditures from their high bracket nonfarm income, and then receive capital gain treatment on the sale of the farm land.

Finance Committee decision.—The Finance Committee added an amendment to the bill which provides for the recapture of soil and water conservation expenditures and land clearing expenditures made with respect to farm land. Thus, gain on the sale of farm land would be treated as ordinary income, rather than as a capital gain, to the extent of these expenditures incurred during the taxable year in which the sale occurred or the 5 preceding taxable years. There is full recapture of these expenditures as ordinary income if the property is sold within 5 years of the time the soil and water expenditures or land clearing expenditures occurred. If the sale occurs from 6 up to 10 years after the expenditures occurred, the amount recaptured is reduced by 20 percent a year, with no recapture in the tenth and subsequent years.

The House bill, to a limited extent, dealt with this problem by treating gain on the sale of farm property as ordinary income to the extent of the amounts in the taxpayer's excess deductions account, or, if less, to the extent of the deductions for these expenditures in the year of sale and the prior 4 years.

E. MOVING EXPENSES

Present law.—A deduction from gross income is allowed for certain moving expenses related to job-relocation or moving to a first job. The deductible expenses are those of transporting the taxpayer, members of his household and their belongings from the old residence to the new residence, including meals and lodging en route.

Two conditions must be satisfied for a deduction to be available. First, the taxpayer's new principal place of work must be located at least 20 miles farther from his former residence than his former principal place of work (or, if the taxpayer had no former place of work, then at least 20 miles from his former residence). Second, the taxpayer must be employed full time during at least 39 weeks of the 52 weeks immediately following his arrival at the new principal place of work.

Generally, the courts have held that reimbursements for moving expenses other than those which may be deducted are includible in gross income.

Problem.—Job-related moves often entail considerable expense in addition to the direct costs of moving the taxpayer, his family, and personal effects to the new job location. These additional expenses include certain costs of selling and purchasing residences, househunting trips to the new job location, and temporary living expenses at the new location while permanent housing is obtained.

Finance Committee decision.—Both the House bill and the committee amendments extend the present moving expense deduction to cover three additional types of job-related moving expenses: (1) travel, meals, and lodging expenses for premove house-hunting trips; (2) expenses for meals and lodging in the general location of the new job location for a period of up to 30 days after obtaining employment; and (3) various expenses incident to the sale of a residence or a settlement of a lease at the old job location or to the purchase of a residence or the acquisition of a lease at the new job location. A limitation of $2,500 is placed on the deduction allowed for these three additional categories of moving expenses. In addition, expenses for the house-hunting trips and temporary living expenses may not account for more than $1,000 of the $2,500.

Both versions of the bill provide that the 39-week test is to be waived if the taxpayer is unable to satisfy it due to circumstances beyond his control. In addition, both versions of the bill require that reimbursements of moving expenses be included in gross income.

The House bill provides that the taxpayer's new principal place of work must be located at least 50 miles (instead of 20 miles as under present law) farther from his former residence than his former place of work. This modification of present law is not accepted by the Finance Committee amendments. The Finance Committee amendments continue the 20-mile test.

The committee amendments also extend the availability of the moving expense deduction (both the categories which are deductible under present law and those made deductible by this bill) to self-employed persons. However, because moves of self-employed persons are more likely to be voluntary than in the case of employees, the amendments provide that the period of time the person is required to work at the new location is extended from 39 weeks to 78 weeks in the case of self-employed persons.

A further modification made by the committee limits the moving expense deduction which may be claimed by a husband and wife, both of whom work, to the amount which could be claimed if only one were employed.

This change applies to taxable years beginning after 1969.

F. MINIMUM TAXES AND ALLOCATION OF DEDUCTIONS

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, under present law, 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.

Problem.—The present treatment imposes no limit on the amount of income which an individual or corporation may exclude from tax as the result of various tax preferences. Individuals with large interest deductions on funds borrowed to carry growth stock, for example, may offset practically all their income in this manner and, as a result, pay little or no tax. Similarly, individuals may pay tax on only a fraction of their economic income, if they enjoy the benefits of accelerated

depreciation on real estate, percentage depletion deductions or intangible drilling expenses. Corporations also may escape tax on all, or a large part of their economic income if they can take advantage of the deductions already referred to, or others which apply only in the case of corporations. As a result, there are large variations in the tax burdens placed on individuals or corporations, with similar economic incomes depending upon the size of the preference income they may have. In general, those individual or corporate taxpayers who receive the bulk of their income from personal services and manufacturing corporations, are taxed at relatively higher tax rates than others. On the other hand, individuals or corporations which receive the bulk of their income from such sources as capital gains or are in a position to benefit from net lease arrangements, from accelerated depreciation on real estate, from percentage depletion, or from other tax-preferred activities tend to pay relatively low rates of tax. In fact, individuals with high incomes who can benefit from these provisions may pay lower effective rates of tax than many individuals with modest incomes. In extreme cases, individuals may enjoy large economic incomes without paying any tax at all. This was true for example in the case of at least 154 returns in 1966 with adjusted gross incomes of $200,000 a year (apart from those with income exclusions which do not show on the returns filed). Similarly, large corporations may pay either no tax at all or taxes which represent lower effective rates on their income than Congress has provided for small corporations. Here, too, there are numerous examples where either no tax was paid or the effective rates of tax on economic income was very low.

A problem also arises from the fact that an individual who receives tax-free income or special deductions can charge the entire amount of his personal deductions to his taxable income. This, in effect, gives him a special tax benefit. He not only excludes the tax-free income from his tax base but also, by charging all his personal deductions against his taxable income, reduces his tax payments on this taxable income. As a result, individuals with substantial tax-free income or special deductions and who also have large personal deductions can wipe out much, or all, of their tax liability on substantial amounts of otherwise taxable income.

Finance Committee decision.—The House bill sought to require individuals with substantial amounts of otherwise tax-free income to pay significant amounts of tax through the use of two basic provisions: the first of these is a limit on tax preferences which required the individual taxpayer to aggregate his taxable income and his tax-free income and to include at least one-half of this amount in his tax base; the second of these provisions required the individual taxpayer to allocate his personal expenses between taxable and nontaxable income, disallowing those deductions attributable to the nontaxable income. Neither of these provisions applied to corporations.

The House bill used both provisions because, if the limit on tax preferences had been used alone, an individual could have nontaxable income amounting to as much as one-half his total economic income and yet not be affected by the provision. Moreover, the half of his income subject to tax, were it not for the allocation of deductions, could be largely, or entirely, offset by the individual's itemized deductions. The House provisions, working hand in hand, result in significant tax increases for individuals with substantial amounts of

tax preference income, but have the effect of adding complexities to the preparation of tax returns for those to whom they apply. In addition, the limit on tax preference does not lend itself well to application with respect to corporate income. This is because a corporation with sufficient tax preferences to be affected often can arrange to escape the impact of these provisions by merging with other corporations with relatively small amounts of tax preference income. This has the effect of averaging the tax preference income over a larger amount of taxable income.

The Finance Committee amendments substitute for the two House provisions a minimum tax on preference income which is made equally applicable to individuals and corporations. This alternative is much simpler than the LTP and allocation of deductions, in part because it is separate from the regular income tax computations. Under the committee approach, tax preference income is subject to a special 5 percent tax payable in addition to the regular income tax. This does not have the effect of treating differently two individuals or corporations with the same amount of tax preference income merely because they have different amounts of taxable income.

The minimum tax of 5 percent provided by the committee amendments applies to the sum of every individual's or corporation's (or estate's or trust's) tax preferences, to the extent they exceed $30,000. This tax base may in some cases be reduced for net operating losses. Generally, of course, it would 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 achieves this effect by allowing 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 is decreased by the unused net operating loss.

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.—This is the excess of investment interest over net investment income (except for financial institutions). 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 rules (secs. 1245 and 1250) to the extent this is attributable to gain from the sale or exchange of property held for investment purposes. Investment income 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, the dividends received deduction, amortizable bond premium, cost depletion, and other deductions attributable to the production of income 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 interest on indebtedness incurred or continued to purchase or carry property held for investment purposes.

(2) Accelerated depreciation on personal property subject to a net lease.—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 to the extent the amortization deduction exceeds straight-line depreciation.

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

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

(7) Tax benefits from stock options.—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 receipt of the stock pursuant to the exercise of the option over the option price of the stock.

(8) Bad debt deductions of financial institutions.—In the case of a bank, saving and loan association, mutual saving 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.

(9) Depletion and intangible drilling and development costs.—This is the sum of two items: the deduction for intangible drilling and development costs (other than those incurred in drilling a nonproductive well) and the excess of the depletion deduction allowance taken for the year over the capitalized cost of the property reduced for depletion taken in prior years. In this case the intangible drilling and development costs, since they are treated directly as a preference item, are treated as a part of the recoverable cost in determining the depletion perference.

(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.

Stock options and capital gains (items (7) and (10) above) which are derived from sources outside the United States, are subject to the minimum tax only if the foreign country taxes them at a preferential rate. The remaining items of tax preference as set forth above include preferences attributable to income derived from sources outside the United States only to the extent that these items result in foreign losses which reduce taxable income derived from sources within the United States. The amount of tax preferences so included is not to exceed the amount of such foreign losses. The foreign tax credit is not to be allowed against the 5-percent minimum tax.

Special rules are provided in order to cover the following situations:

(1) In the case of estates or trusts, the items of tax preference are attributed to the estate or trust and the beneficiaries in the same ratio as the income of the estate or trust. The exemption available to the trust or estate is reduced in similar proportions.

(2) In the case of members of a controlled group of corporations, the $30,000 exemption is to be apportioned equally among the members of the group unless they agree to share the exemption in some other way.

(3) In the case of subchapter S corporations (where the income is taxed to the shareholders), items of tax preference are to be apportioned among the shareholders in the manner consistent with the manner in which a net operating loss is apportioned among the shareholders. However, where capital gains are taxed to both the subchapter S corporation and the shareholder under section 1378 of the code, the capital gains tax preference is subject to the minimum tax at both the corporate and individual levels.

(4) 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 the other tax preferences of the regulated investment company in proportion to the amounts that are distributed to them by the regulated investment company.

(5) In the case of a husband and wife filing separate returns, who each have tax preferences, the $30,000 exemption is to be $15,000 for each spouse.

This provision applies for the calendar year 1970 and subsequent years.

G. INCOME AVERAGING

Present law.—Under present law, income averaging permits a taxpayer to mitigate the effect of progressive tax rates on sharp increases in income. His taxable income in excess of 133⅓ percent of his average taxable income for the prior 4 years generally can be averaged and 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.

Problem.—The 133⅓ percent requirement denies the benefit of averaging to taxpayers with a substantial increase in income and reduces the benefits of averaging for those who are eligible.

Finance Committee decision.—The House bill extends income averaging to long-term capital gains, income from wagering, and income from gifts. The Finance Committee amendments do not accept this change.

Both the House bill and the committee amendments, however, lower the percentage by which an individual's income must increase before the averaging provision is available from 33⅓ percent to 20 percent. This change applies to taxable years beginning after 1969.

The committee amendments also exclude accumulation distributions by trusts from the averaging rule since the tax on such amounts is computed under special rules contained in other provisions of the bill.

H. RESTRICTED PROPERTY

Present law.—Present law does not contain any specific rules governing the tax treatment of restricted stock plans. 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, determined at the time of transfer to the employee, is treated as compensation, provided the stock has increased in value. If the stock has decreased in value, then the lower amount at the time the restrictions lapse is considered to be compensation. Thus, under present regulations there is a deferral of tax with respect to this type of compensation and any increase in the value in the stock between the time it is granted and the time when the restrictions lapse is not treated as compensation.

Problem.—The present tax treatment of restricted stock plans is significantly more generous than the treatment specifically provided in the law for similar types of deferred compensation arrangements. An example of this disparity can be seen by comparing the situation where stock is placed in an employee's trust rather than given directly to the employee subject to restrictions. In the employee-trust situation, 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 compensation in the amount of 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 has none of these benefits, yet he is taxed at the time the stock is transferred to the trust.

Finance Committee decision.—Both the House bill and the committee amendments provide that a person who receives compensation in the form of property, such as stock, which is subject to a restriction generally is to be subject to tax on the value of the property at the time of its receipt unless his interest 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. The restrictions

on the property are not taken into account in determining its value except in cases where the restriction, by its terms, will never lapse. Generally, this provision applies to property transferred after June 30, 1969.

The Finance Committee, while accepting the general format of the House provision, in its amendments provided the following modifications and refinements:

(1) Where an employee transfers (by gift or upon death) property which is subject to forfeiture, the House provision was unclear as to the effect if the property was transferable subject to the forfeiture condition and as to the effect at the time of transfer. The committee amendments provide that the employee is not to be treated as realizing income at the time of such a transfer if the person to whom the property is given remains subject to the forfeitable condition. However, under the committee amendments, the employee (and not the donee) is to be taxed on the value of the property at the time it becomes nonforfeitable.

(2) The committee amendments provide that an interest in property is not to be considered as being forfeitable unless the employer can compel the employee or other holder of the property to return the identical property upon the happening of certain events. Where property is forefeitable under the committee amendments the employee is to be treated as realizing income if he sells or exchanges the property, even though this occurs before the property becomes nonforfeitable.

(3) The committee amendments permit employees receiving property subject to forefeitable restrictions to treat the receipt of the property under these conditions as the receipt of property not subject to forfeitable conditions, and pay tax on the basis of the unrestricted value of the property at that time. If, subsequently, however, the employee's right to the property is forfeited, he would not, if he elects this option, be eligible for a refund for the tax previously paid or receive any deduction for the amount forfeited.

(4) 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.

(5) The committee amendments provide for the deductions for the employer with respect to restricted property to be in the statute rather than merely provided for by Treasury regulations. The deduction will be allowed at the same time as, and the same amount as, the income is taxed to the recipient.

(6) The committee amendments provide that the restricted property rules are not to apply to premiums paid by an employer under nontrusteed annuity plans for an employee who meets the qualification requirements for tax exemption (under section 401(a)). They also provide that the restricted property rules are not to apply to amounts

excluded from gross income (under section 403(b)) in the case of annuities purchased for an employee by an educational or charitable organization (exempt under section 501(c)(3)).

(7) The committee amendments make clear that the amount subject to tax in the case of nonexempt trusts and nonqualified annuities when the employee's interest becomes nonforfeitable is the value at that time of its interest in the trust (or the then value of the annuity contract). The value of 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).

(8) The committee amendments provide that in the case of nonexempt trusts, the employer is to be allowed a deduction at the time the amounts are taxed to the employee. (Under present regulations, no deduction is ever allowed in these cases where taxation of the income to the recipient is deferred.)

(9) The general effective date of the restricted property—namely, property transferred after June 30, 1969—under the House bill does not apply where property is transferred before February 1, 1970, pursuant to a written plan adopted and approved before July 1, 1969. The committee amendments allow additional time up to May 1, 1970, for the transfer of property in these cases.

(10) The House bill provides that the new restricted property provision is not to apply in the case of property transferred after June 30, 1969, where the property is transferred pursuant to a binding written contract entered into before April 22, 1969. The committee amendments also provide an exception for binding contracts with a third party to pay key employees a determinable amount of stock until a fixed number of shares has been transferred. In this latter case, the committee's amendments provide that the new rule is not to apply to property transferred before January 1, 1973.

I. ACCUMULATION TRUSTS, MULTIPLE TRUSTS, ETC.

Present law.—A trust that distributes all its income currently to its beneficiaries is not taxed on this income; instead the beneficiaries include these distributions in their income for tax purposes.

An accumulation trust (a trust where the trustee is either required, or is given discretion to accumulate income for future distributions to beneficiaries), however, is taxed on its accumulated income at individual rates. When this accumulated income is distributed to the beneficiaries, they are in some cases 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. This throwback rule, however, only applies with respect to 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 this limitation, the throwback rule does not apply to distributions of accumulations prior to the beneficiaries attaining age 21, distributions to meet a beneficiary's emergency needs, a distribution of accumulated income which is a final distribution (made more than 9 years after the last transfer to the trust), distributions not in excess of $2,000, and certain other periodic mandatory distributions under trusts created before 1954.

Problem.—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. 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 substantially limit the effectiveness of the rule.

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.

Finance Committee decision.—The House bill and the Finance Committee amendments provide that in the case of accumulation trusts (including multiple trusts), the beneficiaries are to be taxed on the distributions of accumulated income in substantially the same manner as if the income had been distributed to the beneficiaries when it was earned by the trust. The taxes paid by the trust on the income, in effect, are to be considered as paid by the beneficiary for this purpose. A shortcut method of computing the tax on the accumulated income is provided under which the tax attributable to the distribution, in effect, is averaged over the number of years in which the income was earned by the trust.

The Finance Committee and House versions of the bill are generally the same except for the following modifications:

(1) 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.

(2) The committee amendments provide an interest charge to cover the tax payments by the income beneficiaries which are deferred (to the extent their 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. The charge is based on simple interest computed for the number of years of tax deferral involved (a simpler method of computation is available where the shortcut method is used). 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.

(3) Except in the case of "simple trusts" (or until the first year other trusts become accumulation trusts) capital gains, even though allocated by the trustees to the corpus of the trust, are to be taken into account separately in determining the additional tax payable by the beneficiary (over and above the tax previously paid by the trust) with respect to the distribution made to such beneficiary.

(4) In the case of the so-called "shortcut" method for the computation of any additional tax payable by the beneficiary upon the distribution of accumulated income, the committee amendments provide that the 3 years to be taken into account in determining the base for the income computation are the 3 years immediately prior to the current year (rather than the 2 immediately prior years plus the current year). The committee amendments provide that the "shortcut method" is not to be available to the taxpayer if, during any of the preceding taxable years in which an accumulation distribution was deemed made, prior accumulation distributions were also deemed to have been made by two or more other trusts to the taxpayer. The committee amendments also provide that the so-called exact method (as well as the short cut method) of computation is to be available with respect to accumulations of income in years prior to the time the beneficiary was in existence.

J. MULTIPLE CORPORATIONS

Present law.—There are several provisions in the code which are designed to aid small corporations. The most important of these provisions is the surtax exemption. As the result of the surtax exemption corporations are taxed at only 22 percent, instead of at 48 percent on the first $25,000 of taxable income.

Present law permits a controlled group of corporations to each obtain a $25,000 surtax exemption if each of the corporations pays an additional 6 percent tax on the first $25,000 of taxable income.[1] This generally reduces the tax savings of the surtax exemption from $6,500 to $5,000.

Other provisions in the code designed to aid small corporations 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; and (2) the provision which allows an additional first year depreciation deduction equal to 20 percent of the cost of the property (limited to $10,000 per year).

Problem.—Large corporate organizations have been able to obtain substantial benefits from these provisions by dividing income among a number of related corporations. Since these are not in reality "small businesses" it is difficult to see why they should receive tax benefits intended primarily for small business, whether or not they have incorporated the businesses separately for business, as distinct from tax, reasons.

Finance Committee decision.—The House bill and the Finance Committee amendments provide that a group of controlled corporations may have only one of each of a series of special provisions designed to aid small corporations. The most important of these is the surtax

[1] The election to take multiple surtax exemptions and to pay the additional 6 percent tax is generally desirable where the group has a combined income of about $82,500 or more. Below this figure the allocation of a single surtax generally produces a lower tax.

exemption and the accumulated earnings credit. A controlled group of corporations is limited to one $25,000 surtax exemption and one $100,000 accumulated earnings credit after a transition period.

The House bill provides an 8-year transition period, reducing the additional surtax exemptions in excess of one by $3,125 in each of the years 1969 through 1976. 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 $5,000 in each of the years 1970 through 1974.

Both the House and the Senate amendments 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 one individual, estate, or trust. Both versions expand this definition to include two or more corporations which are owned 80 percent or more by five or fewer persons, provided 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 is treated as owning only 30 percent of each corporation identically.

The Finance Committee amendments make the following modifications in the House provisions:

(1) Under the House bill the dividends received deduction is increased gradually from 85 percent to 100 percent over the transition period in the same proportion as the denial of the multiple surtax exemptions. The committee amendments also increase the deduction gradually over the transition period; in this case by 3 percentage points a year.

(2) Under the present consolidated return regulations, preconsolidation losses for a corporation in a group claiming multiple surtax exemptions may be carried over after the consolidation only against the income of the corporation which sustained the losses. The House bill would have modified these regulations to permit net operating losses for 1969 and subsequent years to be taken as a deduction against the income of other members of the group in the same proportion as the reduction in the additional surtax exemptions for the group. The Finance Committee amendments do not permit any preconsolidation net operating losses during the transition period to be carried over and used against the income of other members of the group. The consolidation of the income and losses is only to be allowed for years after the end of the transition period. However, the committee amendments permit corporations which have used multiple surtax exemptions for past years to elect to change over immediately to a consolidated return basis (foregoing any part of the multiple exemptions during the transition period). They provide that corporations which do so may use net operating loss carryovers to offset income of other corporations in the consolidated group, if the group agrees to give up multiple surtax exemptions for any prior years in which a loss was sustained which is offset against income of another corporation in the group.

(3) 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.

K. CORPORATE MERGERS, ETC.

1. Disallowance of Interest Deduction in Certain Cases

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.

Problem.—It is a difficult task to draw an appropriate distinction between dividends and interest, or equity and debt. Although this problem is a long-standing one in the tax laws, it has become of increasing significance in recent years because of the increased level of corporate merger activities and the increasing use of debt for corporate acquisitions 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. Various characteristics tend to make a bond or debenture more nearly like equity than debt. 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 debt 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 stockholdings, 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.

In summary, in many cases the characteristics of an obligation issued in connection with a corporate acquisition make the interest in the corporation which it represents more nearly like a stockholder's interest than a creditor's interest, although the obligation is labeled as debt.

Finance Committee decision.—In general, the House bill and Finance Committee amendments disallow a deduction for interest on bonds issued in connection with the acquisition of a corporation where the bonds have specified characteristics which make them more closely akin to equity.

The disallowance rule under both versions of the bill only applies to bonds or debentures issued by a corporation to acquire stock in another corporation or to acquire at least two-thirds of the assets of another corporation. In addition, the disallowance rule only applies to bonds or debentures which have three characteristics. Two of these characteristics are substantially the same in the House bill and the committee amendments. They provide that the interest disallowance rule is to apply where the bonds are subordinated to the corporation's trade creditors and also are either convertible into stock, or are issued as an investment unit including warrants.

The House bill provides that the interest disallowance rule is to only apply where the ratio of debt to equity of the acquiring corporation (including affiliated corporations) is more than 2 to 1, or where the annual interest expense on its indebtedness is not covered at least

three times over by its earnings. The Finance Committee amendments apply the interest disallowance rule in this respect in the same general manner as the House provision. However, under the committee amendments, for the interest disallowance rule to apply, the ratio of debt to equity must exceed 4 to 1 or the annual interest expense on the indebtedness of the corporation must not be covered as much as two times over by its earnings.

The House bill provides an exception from the rule described above for up to $5 million a year of interest on obligations to which the interest disallowance rule would otherwise apply. The amount of this exception is reduced by interest on debt used for acquisition purposes which is not subject to the disallowance rule. The committee amendments retain this provision but for this purpose take into account only interest on obligations issued after December 31, 1967.

Neither the House bill nor the committee amendments apply to debt issued in tax-free acquisitions of stock of newly formed or existing subsidiaries or in connection with acquisitions of foreign corporations if substantially all of the income of the foreign corporation is from foreign sources.

In addition to the committee amendments described above the following modifications or refinements are also made in the House bill:

(1) The committee amendments provide that the subordination test referred to above is to include any obligation which, by its terms (other than by operation of law), is subordinated in right of payment to any substantial amount of the corporation's indebtedness.

(2) The committee amendments provide that the debt equity and interest coverage test, in the case of a corporation engaged in the lending, finance, or banking business, are to be applied by reducing its indebtedness (and the interest thereon) by amounts owed to the corporation with respect to its lending, finance, or banking business (and the interest thereon).

(3) The committee amendments provide that the interest disallowance rule is no longer to apply after a corporation for a period of at least 3 consecutive years has brought itself down below the 4-to-1 debt equity ratio and the interest charges over the 3-year period are covered more than two times by the earnings of the corporation.

(4) The committee amendments provide that the interest disallowance rule is to apply where a corporation acquires at least two-thirds of the "operating assets" (excluding cash) rather than where it acquires two-thirds of a company's "total" assets.

(5) The committee amendments provide that the bill is not to apply to acquisitions of stock of a corporation where the total interest of the acquiring corporation in the other corporation does not exceed 5 percent.

(6) The committee amendments make this provision applicable to indebtedness incurred after October 9, 1969 (rather than May 27, 1969, as in the House bill). They also make the provision inapplicable where stock or assets of a corporation were acquired pursuant to a binding contract entered into before this effective date.

(7) The committee amendments make this provision inapplicable where a corporation has on or before October 9, 1969, acquired at least 50 percent of the stock of a corporation, to the extent the corporation subsequently acquires the additional stock necessary to provide control for tax purposes (80 percent).

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The committee amendments also provide a statutory provision authorizing the Internal Revenue Service to issue regulations distinguishing between debt and equity. Statutory guidelines are provided for this purpose and the delineation is for all purposes under the Internal Revenue Code. This grant of authority is not limited to cases involving acquisitions.

2. Limitation on Installment Sales Provision

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, it is understood that some tax counsel have advised that the method is so available.

Problem.—The allowance of the installment method of reporting where readily marketable debentures or securities are received by the seller of property is not consistent with the purpose for which the installment provision was adopted. This method presumably was initially made available because of the view that where a seller received a debt obligation he did not have cash, or the equivalent of cash, on hand which would provide him with funds to pay the tax due on the gain. This problem, however, does not exist where the seller receives readily marketable securities.

Finance Committee decision.—The House bill and the Finance Committee amendments provide that where bonds have interest coupons attached, are in registered form or have other features which make them readily tradeable in the market, these bonds are to be considered as payments in the year of the sale for purposes of the installment sales provision relating to sales of real property and casual sales of personal property (including the rule which denies the installment method on a transaction where more than 30 percent of the sales price is received in the first year). The committee amendments add obligations which are payable on demand to the category of bonds that are to be treated as payments in the year of sale. The committee amendments, however, exclude from the category of bonds or debentures in registered form (which otherwise would be considered as payments received in the year of sale) bonds or debentures which are nontransferable except by operation of law or which otherwise are not readily tradeable on an established securities market.

The House provision would have applied to sales occurring after May 27, 1969. The committee amendments make the new rules effective with respect to sales occurring after October 9, 1969. In addition, the amendments provide that the new rules are not to apply to a sale made pursuant to a binding contract entered into before October 9, 1969.

The House bill in addition to the provision described above would have denied the use of the installment method unless the payment of the principal of the loan, or the payment of the principal of the loan and the interest taken together, were spread relatively evenly over the installment period. This requirement would have been satisfied if at least 5 percent of the principal was paid by the end of

the first quarter of the installment period, 15 percent was paid by the end of the second quarter and 40 percent by the end of the third quarter. The committee amendments delete this provision from the bill.

3. Original Issue Discount

Present law.—Under present law, original issue discount arises when a corporation issues a bond for a price less than its face amount. (The amount of the discount is the difference between the issue price and the face amount of the bond.) The owner of the bond is not taxed on the original issue discount until the bond is redeemed or until he sells it, whichever occurs earlier. In addition, only that portion of the gain on the sale of the bond equal to the part of the original issue discount attributable to the period the taxpayer has held the bond is taxed at ordinary income rates.

The corporation issuing the bond, on the other hand, is allowed to deduct the original issue discount over the life of the bond.

Problem.—Present law results in a nonparallel treatment of original issue discount between the issuing corporation and the bondholder. The corporation deducts a part of the discount each year. On the other hand, the bondholder is not required to report any of the discount as income until he disposes of the bond. Although it is likely that the discount will be deducted by the corporation, it is probable that much of the ordinary income is not being reported by the bondholders.

Finance Committee decision.—The House bill and the committee amendments provide that the bondholder and issuing corporation are generally to be treated in a consistent manner with respect to original issue discount. Bondholders are to include the original issue discount in income ratably over the life of the bond. This rule applies to both the original bondholder and subsequent bondholders. (Issuing corporations already take deductions ratably over this period.) Corporations issuing bonds in registered form are to be required to furnish the bondholder and the Government with an annual information return indicating the amount of original issue discount to be included in income for the year.

The committee amendments provide an exception to the rule specified above to the effect that original issue discount must be included in the bondholder's income ratably over the life of the bond. The exception applies in the case of life insurance companies which already accrue discount under the Internal Revenue Code on a basis which produces essentially the same result as a ratable accrual.

The House provision would have been effective with respect to bonds issued on or after May 28, 1969. The committee amendments make these rules applicable to debt obligations issued after October 9, 1969. In addition, the new rules are made inapplicable to debt obligations issued after this effective date which are issued pursuant to a binding contract entered into before this date.

4. Convertible Indebtedness Repurchase Premiums

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 is, however, at least one court case which holds to the contrary in that it allowed the deduction of the entire premium. In addition, there are several pending court cases which have been filed by taxpayers to test the validity of the Service's position on this matter.

Problem.—A corporation which repurchases its convertible indebtedness is, in part, repurchasing the right to convert the bonds into its stock. Since a corporation may not deduct the costs of purchasing its stock as a business expense, it would appear that the purchase of what, in effect, is the right to purchase its stock should be treated in the same manner.

Finance Committee decision.—The House bill and Finance Committee amendments provide that a corporation which repurchases its convertible indebtedness at a premium may deduct only that part of the premium which represents the cost of borrowing and not that portion attributable to the conversion feature. Generally, the deduction is to be limited to the normal call premium for nonconvertible corporate debt except where the corporation can satisfactorily demonstrate that a larger amount of the premium is related to the cost of the borrowing.

The provision in the House bill would have applied to repurchases of convertible indebtedness after April 22, 1969. The committee amendments change this effective date so that it will apply to repurchases of convertible indebtedness after October 9, 1969

L. STOCK DIVIDENDS

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. Under present law, the recipient of a stock dividend under these conditions is taxed as if he had received cash.

Problem.—In recent years, considerable ingenuity has been used in developing methods of capitalizing corporations in such a way that shareholders can be given the equivalent of an election to receive cash or stock, but at the same time permitting stockholders who choose stock dividends to receive them tax free. Typically, these methods involve the use of two classes of common stock, one paying cash

dividends and the other stock dividends. Sometimes, by means of such devices as convertible securities with changing conversion ratios, or systematic redemptions, the effect of an election to receive cash or stock can be achieved without any actual distribution of stock dividends, and therefore without any current tax to the stockholders whose interests in the corporation are increased. In addition, some of these plans have the effect of satisfying the claim of the preferred stockholders to dividends with stock distributions, year after year.

Finance Committee decision.—The House bill and the committee amendments provide that a stock dividend is to be taxable if one group of shareholders receives a distribution in cash and there is an increase in the proportionate interest of other shareholders in the corporation. In addition, the distribution of convertible preferred stock is to be taxable unless it does not cause such a result.

To counter the various devices by which the effect of a distribution of stock can be disguised, both versions of the bill give the Treasury Department regulatory authority to treat as distributions changes in conversion ratios, systematic redemptions, and other transactions which have the effect of creating disproportionate distributions.

The two versions of the bill also deal with the related problem of stock dividends paid on preferred stock. Since preferred stock characteristically pays specified cash dividends, stock dividends on preferred stock (except antidilution distributions on convertible preferred stock) are a substitute for cash dividends and therefore all stock distributions on preferred stock (except for antidilution purposes) are taxable under both versions of the bill. An antidulution distribution occurs where the conversion ratio of the preferred stock is increased to take into account a stock dividend (or stock split) with respect to the stock into which it can be converted.

The committee intends to make it clear that isolated redemptions of stock are not to be considered as resulting in taxable distributions to stockholders whose stock is not redeemed.

The committee amendments provide a de minimis rule where the disproportionate distribution rules are not to apply. If a distribution which results in an increase in the proportionate interests of other shareholders is made but if this distribution and all prior distributions of this type to the same class of shareholders made during the last 36 months does not have the effect of increasing the proportionate interest of other shareholders in the assets or earnings and of the corporation by more than 1/10th of 1 percent, the distribution is not to result in a stock dividend being taxable. This test is applied on a distribution by distribution basis, always taking into account any prior distributions in the prior 36 months (including distributions before the effective date of this act).

Generally, under the House bill and the committee amendments the provisions apply (subject to certain transitional rules) to distributions made after January 10, 1969 (or in those cases where the new rules in the bill do not follow the regulations previously published, after April 22, 1969). The House bill contains a transitional rule for stock dividends paid on stock that was outstanding on the effective date. This provision was intended to apply only where the corporation's dividend policy and capital structure on the effective date 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 where a corporation had two classes of stock out-

standing before the effective date but had not prior to the effective date used them in a way which would have given rise to tax under the new rule, the corporation cannot begin after the effective date making disproportionate distributions of the kind covered by the bill (without payment of tax).

If the transitional rule applies where two classes of stock were in existence before the effective date, one convertible into the other and one paying cash dividends and the other paying stock dividends, it is unclear under the House provision whether additional issues of the cash dividend paying stock after the effective date could be made. The committee report implies they could not. Further, the House provision does not permit the issuance of the stock dividend paying stock in such a situation. The committee amendments provide that a corporation which qualifies for the transitional rule is to be able to continue issuing one class of stock, but the stock which may be issued in such a case is to be the larger of the two classes. (This would usually be common stock of the corporation.)

M. FINANCIAL INSTITUTIONS

1. Commercial Banks—Reserves for Losses on Loans

Present law.—Commercial banks, as a result of Revenue Ruling 65-92 (C.B. 1965-1, 112), now have the privilege of building up a bad debt reserve equal to 2.4 percent of outstanding loans not insured by the Federal Government. Alternatively, their reserve may be based on their actual loss experience. 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. In 1968, Revenue Ruling 68-630 (C.B. 1968-2, 84) clarified the loan base used for computing the allowable bad-debt reserve generally to include only those loans on which banks can suffer an economic loss.

Problem.—By allowing commercial banks to build up bad-debt reserves equal to 2.4 percent of uninsured outstanding loans, present law gives them 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.

Finance Committee decision.—The Finance Committee amendments provide that in the future the deduction allowed commercial banks for additions to bad-debt reserves is to be limited to 1.8 percent of eligible loans, or the amount called for on the basis of their own experience as indicated by losses for the current year and the 5 preceding years. Banks presently below the 1.8-percent reserve will be permitted to bring their reserves up to this level over a 5-year period. Banks with bad-debt reserves in excess of 1.8 percent of eligible loans are not to be permitted to add to these reserves unless additions are justified on the basis of their own experience. However, these banks will not be required to reduce their existing level of reserves. Moreover, they will be allowed in any event to deduct their actual bad debt losses during the year.

The House bill differs from the committee amendments in that it would, in the future, have limited the deduction allowed commercial banks for additions to bad-debt reserves to the amount called for on

the basis of their own bad debt loss experience. In addition, the House provision would have provided banks with net operating loss carry-backs for 10 years instead of the 3 provided under present law.

The committee amendments apply to taxable years beginning after July 11, 1969. This is the same effective date as in the House bill.

2. Small Business Investment Companies and Business Development Corporations

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.

Problem.—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 which have been in existence for only a few years. Such companies, although they may subsequently realize losses, initially are unlikely to have much if any losses.

Finance Committee decision.—The Finance Committee amendments provide that a new small business investment company, or a new business development corporation, may during the first 10 years of its experience base its bad-debt reserves upon the industry average. This adopts identical provisions of the House bill with respect to these two types of organizations.

3. Mutual Savings Banks, Savings and Loan Associations, etc.

Present law.—Mutual savings banks, savings and loan associations, and cooperative banks are permitted to 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 provide for the deduction of (1) 60 percent of taxable income, or (2) 3 percent of qualifying real property loans. Under the first 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). Under the second 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.

A savings and loan association and a cooperative bank are entitled to use these special reserve methods only if they meet a comprehensive set of investment standards, which 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. Mutual savings banks, however, 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.

Problem.—In 1952 Congress repealed the exemption of these institutions from Federal income tax and subjected them to the regular corporate income tax. 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 by providing the special alternative methods for these institutions in the computation of their bad-debt reserve. Although these methods are more restrictive than prior law, they still provide highly favorable treatment for the bad-debt reserves of these institutions.

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, but most mutual savings banks use the 3-percent method and as a result have been able to avoid substantially all Federal income taxes.

Finance Committee decision.—Both the House bill and the committee amendments revise the tax treatment of mutual savings banks, cooperative 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. In both cases the balance of this reserve for losses on qualifying real property loans (as under present law) may not exceed 6 percent of these loans outstanding at any time.

Both the House bill and the committee amendments also revise the present investment standards applicable to savings and loan associations by liberalizing the composition of the qualifying assets. In addition, these liberalized standards are applied 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.

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 allocated the deduction between the portion of the income subject to tax and the portion which is allowed as a bad-debt reserve deduction. 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 banks 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 deducted toward 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 corporate 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.

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 a predominantly residential 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. 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 committee's provision also gives mutual savings banks and savings and loan institutions the option of computing their bad debt reserves under the commercial bank formula (1.8 percent of eligible outstanding loans) in lieu of the bad debt reserves outlined above. 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's bill requires 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 generally 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.

These amendments under both the House bill and the committee amendments are effective for taxable years beginning after July 11, 1969.

4. Treatment of Bonds Held by Financial Institutions

Present law.—Commercial banks and mutual savings institutions receive special tax treatment in regard to their transactions in bonds and other corporate and governmental evidences of indebtedness. Like other taxpayers, they can treat long-term gains from such transactions as long-term capital gains for tax purposes. However, unlike other taxpayers, they can treat capital losses from such transactions as ordinary losses and may deduct such losses without limit from ordinary income.

Problem.—The present nonparallel treatment of gains and losses on bond transactions by financial institutions appears to have 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.

Finance Committee decision.—Both the House bill and the committee amendments provide parallel treatment for gains and losses derived by financial institutions on transactions in corporate and governmental bonds and other evidences of indebtedness. Under both versions of the bill, financial institutions are to treat net gains from these transactions as ordinary income, instead of as capital gains, and they are to continue to treat net losses from such transactions as ordinary losses in the same manner as under present law.

The House provision would have applied to bonds which are sold or exchanged in taxable years beginning after July 11, 1969. The committee amendments provide the same rule for indebtedness acquired after July 11, 1969. However, in the case of indebtedness held by the financial institutions on or before that date, this indebtedness, if sold at a gain, is to continue to receive capital gains treatment if the gain is realized within 5 years, but only if it is a net capital gain, taking into consideration transactions on all securities in any year.

Under present law, the capital gains and ordinary loss treatment for bonds and other forms of indebtedness is available only in the case of commercial banks and, in limited circumstances, for small business investment companies. Under the bill, this treatment also is to be available in the case of small business investment companies and business development corporations. Under present law, these financial institutions presently receive capital gain and capital loss treatment with respect to the sale or exchange of indebtedness. Under the committee amendments, these institutions are to receive ordinary gain and ordinary loss treatment in all cases after the 5-year transitional period. In the transition period, however, they may continue to receive capital gain and capital loss treatment for the sale or exchange of these various forms of indebtedness if they so elect for the entire transition period.

5. Mergers of Savings and Loan Associations

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 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 (sec. 593) 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; however, if the merger is not tax-free, then the bad-debt reserve is restored to income and taxed (sec. 593(f)).

Problem.—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.

Finance committee decision.—The committee amendments provide that in those cases where section 381 applies (relating to carryovers in certain corporate acquisitions which qualify 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 provision in the House bill.

6. Foreign Deposits in U.S. Banks

Present law.—Present law provides special rules, for purposes of the income tax and the estate tax, for the treatment of U.S. bank deposits, and the interest thereon, of foreign persons.

In general the effect of these special rules is to exempt this type of interest income received by foreign persons from U.S. tax and to exempt the deposits from the estate tax. 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 otherwise would be subject to income tax and the bank deposits themselves would be subject to the estate tax.

Problem.—Congress provided, in 1966, that the special treatment accorded U.S. bank deposits of foreign persons should be terminated. It was believed, however, that an immediate elimination of the special rules might have a substantial adverse effect on the balance of payments. Accordingly, it was decided to postpone the elimination of the special rules until the end of 1972. In view of the continuing deficit in the balance of payments, it appears that our balance-of-payments situation might be adversely affected to a substantial degree if the special treatment were removed at the end of 1972.

Finance Committee decision.—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, income from deposits in the United States by nonresident alien individuals which is not effectively connected with a U.S. business will be exempt from U.S. income tax until the end of 1975 under both versions of the bill.

The committee amendments revise the treatment of U.S. bank deposits of foreign persons to provide the same treatment for deposits in U.S. branches of a foreign bank as now exists in the case of deposits in U.S. banks.

N. DEPRECIATION ALLOWED REGULATED INDUSTRIES

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.

Problem.—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 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. 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.

Finance Committee decision.—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 under the committee amendments as provided below), unless the appropriate regulatory agency permits a change as to that property.[1]

Both versions of the bill in the case of new property provide 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 normalization reserve from the base upon which the agency computes the company's rate of return.

Both the House bill and the committee amendments provide that the rules set forth above 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 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 in one of the regulated industries 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 to permit it to shift to the normalization method with the permission of the regulatory agency. This election applies only to new property. To provide time for the regulatory agency to authorize a change from flow through to normalization (if it wishes to), the election would not take effect until 1971. Since the utility could no longer use accelerated depreciation unless the regulatory agency permits it to normalize, the agency would not be able to impute accelerated depreciation and flow it through.

A number of other changes of lesser importance are also made by the committee amendments. They are as follows:

(1) Oil pipelines are removed from the category of industries 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 the industries covered by the provision.

(2) 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

[1] That is, the bill does not require the taxpayer to flow through, but it also does not affect any power the regulatory agency might have to require the taxpayer to flow through.

not require that additions be to a separate account described as a "reserve for deferred taxes."

(3) The committee amendments provide that the requirement of normalizing is not met by simply normalizing on 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 prevents a revenue loss which would occur if rates are set based on the flow-through method.

(4) 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 method used on the return is normalized. In other words, differences resulting from different useful lives ("guideline" versus "engineering") or capitalizing some items on the books while expensing them on the return, need not be normalized. However, differences such as those between 200-percent (or 150-percent) declining balance and straight line must be normalized. However, this rule is to be applied for the future only.

(5) 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, as under the House bill).

(6) 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.

(7) 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 expenses 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, in certain limited circumstances involving regulatory agency hearings that began before April 22, 1969, a utility might be permitted to change to flow through. All of these involve situations where the utility had committed itself to a change in its dealings with the Internal Revenue Service or with the appropriate regulatory agency.

O. TREATMENT OF DEPRECIATION FOR EARNINGS AND PROFITS

Present law.—A dividend is defined under present law as a distribution of property by a corporation to its shareholders out of 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.

Problem.—Tax-free dividends (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.

Finance Committee decision.—The House bill and the committee amendments provide that for purposes 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 deductions of depreciation over the useful life of the asset. This provision does not affect the amount of depreciation that can be deducted in determining the corporation's Federal income tax.

The committee amendments provide that this rule as to the method of computing earnings and profits is not to apply in the case of a foreign corporation. Thus, for example, the amount of the foreign tax credit allowed a company receiving dividends from a foreign corporation will be computed as under existing law and will not be affected by the provisions of this bill.

This provision applies to earnings and profits for taxable years beginning after June 30, 1972.

P. NATURAL RESOURCES

1. Percentage Depletion

Present law.—At present, percentage depletion is granted to a wide range of minerals. The 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. 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 eligible for percentage depletion at the 15-percent rate.

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. In any case where depletion based upon cost is higher than percentage depletion, the higher amount is allowed as a deduction.

Problem.—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. However, 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.

It has been argued that if percentage depletion rates are viewed as a needed stimulant at the present time, they are higher than is needed to achieve the desired increase in reserves.

Finance Committee decision.—The Finance 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. In addition, the committee amendments provide that in the case of oil and gas producers with less than $3 million of gross income from oil and gas production, the "net income" limitation on the allowance for depletion is to be increased from 50 percent to 65 percent of the net income from the property.

The House bill would have decreased the percentage depletion rate for oil and gas from 27½ percent to 20 percent. It also would have made percentage depletion unavailable in the case of foreign production of oil and gas. No changes were made in the House bill with respect to the net income limitation.

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 would have 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 (and committee bill)	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

The committee amendments also made certain other changes with respect to the depletion allowance for other minerals. In the case of gold, silver, and copper, they increase the 50-percent net income limitation to 70 percent. In addition, the committee amendments clarify

the treatment for percentage depletion purposes of minerals extracted from saline lakes within the United States. Under present law, the Internal Revenue Service has held that percentage depletion is not available with respect to minerals extracted from the Great Salt Lake because it is considered to be an inexhaustible source. The committee amendments provide that, except for salt and water, the various depletion rates will be allowed for minerals extracted from the Great Salt Lake and other perennial saline lakes in the United States.

2. Mineral Production Payments

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. Depending on how a production payment is created, it may be classified as a carved-out production payment, or it may constitute a 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 the 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.

Problem.—The use of carved-out production payments constitutes a problem because they are being employed to circumvent the limitations on the depletion deduction and the foreign tax credit and to distort the benefits that the net operating loss provisions were designed to provide. In addition, in A–B–C transactions, taxpayers are able to

pay off what is essentially a purchase money mortgage with before-tax dollars rather than after-tax dollars.

Finance Committee decision.—Both the House bill and the Finance Committee amendments provide, in general, that carved-out production payments and retained payments (including ABC transactions) are to be treated as a loan by the owner of the production payment to the owner of the mineral property. In the case of a carved-out production payment, both versions of the bill provide that the payment is to be treated as 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 are not to be taxable to him. However, as income is derived from the property subject to the carve-out, that income, including the portion used to satisfy the production payment, is taxable to the owner of the property, subject to the depletion allowance. The cost of producing minerals used to satisfy carved-out production payments is to be deductible when incurred.

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.

In the case of retained production payments (that is, the sale of mineral property subject to a production payment), both versions of the bill provide that the production payment is to be treated as a purchase money mortgage loan (rather than as an economic interest in the mineral property). As a result, the income derived from the property which is used to satisfy the payment is to be taxable to the owner of the mineral property subject to the allowance for depletion. In addition, the production costs attributable to producing the minerals used to satisfy the production payment are to be deductible by the owner of the working interest in the year incurred.

Under the House bill, these rules would have applied to mineral production payments created on or after April 22, 1969, other than production payments created before January 1, 1971, pursuant to a binding contract entered into before April 22, 1969. The committee amendments advance the April 22, 1969, date in both of these cases to October 9, 1969.

The committee amendments also provide two transition rules. First, they permit taxpayers to elect to apply the new rules with respect to carved-out production payments to such payments which were sold after December 31, 1967 (in the case of a calendar year taxpayer). As a result, where this election is made these payments will be treated as a loan rather than as a sale. Any refunds paid as a result of this provision are to be paid without interest. The second transition rule provided by the committee amendments is a modification of a House bill transition rule. The rule under the House bill would have allowed payments to be carved out during the part of a taxable year on or after April 22, 1969, to the extent of drilling or development costs incurred during the portion of the taxable year occurring before April 22, 1969. The amount carved out in this manner could be used under the House provision only to reduce or offset such costs. It could not be used to increase a percentage depletion deduction or foreign tax credit. The committee amendments modify this rule to provide that the new rules with respect

to carved-out production payments are not to apply except for percentage depletion and foreign tax credit purposes to payments sold during the part of the taxpayer's year which occurs after October 9, 1969, to the extent the production payments offset a net operating loss which would have occurred in the taxable year in the absence of the carved-out production payments. In no event, however, are the amount of the carved-out production payments qualifying for this treatment plus the amount of payments sold by the taxpayer in the prior part of his taxable year to exceed the amount of carved-out payments sold by the taxpayer during his preceding taxable year.

3. Mining Exploration Expenditures

Present law.—Present law allows a taxpayer to elect to deduct, without dollar limitation, mining exploration expenditures (that is, exploration expenditures for any ore or mineral other than oil or gas) which are made prior to the development stage of the mine. The availability of this deduction is limited to mines located in the United States or on the Outer Continental Shelf. When a mine reaches the producing stage, the exploration expenditures previously deducted are recaptured, generally by disallowing the depletion deduction with respect to the mine.

A taxpayer who does not elect this unlimited mining exploration expenditure deduction is allowed a limited deduction for exploration expenditures (whether on domestic or foreign mines) without the recapture rules applying. The total deduction under this limited provision for all years may not exceed $400,000.

Problem.—The allowance of a current deduction for exploration expenditures without applying the recapture rules under the limited deduction provision is not justified in view of the recapture rule applicable to the unlimited deduction.

Finance Committee decision.—The House bill and the committee amendments amend existing law to provide that insofar as future mining exploration expenditures are concerned, the general recapture rules are to apply in all cases. Taxpayers may still continue to deduct expenditures for foreign (and oceanographic) explorations to the extent permitted under present law (generally up to a maximum of $400,000).

The committee amendments also provide that taxpayers who have elected to deduct mining exploration expenditures under the limited provisions of present law are to be deemed (unless the taxpayer notifies the Treasury to the contrary) to have made an election with respect to expenditures made after the effective date of this provision to deduct the expenditures under the unlimited provision. The committee also wants to clarify its intent as to the treatment (under existing law as well as under the bill) of expenditures which are incurred during the development or producing stage of a mine. It is the intent of the committee that 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 productive 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.

The House provision applied to mining exploration expenditures made after July 22, 1969. The committee amendments apply to exploration expenditures made after December 31, 1969.

4. Treatment Processes in the Case of Oil Shale

Present law.—The depletion allowance for oil shale under present law is applicable only to the value of the rock itself after extraction and crushing—which has little value. Liquid oil from wells, on the other hand, has considerable value.

Problem.—Existing levels of technology do not permit oil shale to be produced on a basis competitive with oil produced from wells. Percentage depletion does not operate effectively as an incentive to improvements in oil shale technology because percentage depletion on oil produced from oil shale is substantially less than percentage depletion on oil produced from wells.

Finance Committee decision.—The House bill and Finance Committee amendments extend the point at which percentage depletion is computed in the case of oil shale until after extraction from the ground, through crushing, loading into the retort and retorting. However, this is to be before hydrogenation or any refining process or any other process subsequent to retorting.

5. Continental Shelf Areas

Present law.—It is not clear under present law whether for purposes of the exploration for, or exploitation of, mineral resources in the continental shelf area of a country over which it exercises tax jurisdiction under the principles of international law, that area is considered for U.S. tax purposes as a part of the country.

Problem.—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 on a continental shelf area and in the application of the foreign tax credit with respect to this income.

Finance Committee decision.—The House bill did not deal with this subject. The Finance Committee amendments provide that for purposes of applying the income tax provisions with respect to natural resources, the term "United States" 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. A similar definition of "foreign country" also is provided. This does not mean, however, that a foreign country will by reason of this be treated as a country which is contiguous to the United States.

Q. CAPITAL GAINS AND LOSSES

1. Alternative Tax Rate for Individuals

Present law.—One-half of an individual's net long-term capital gains are included in taxable income and, accordingly, are taxed at regular tax rates. However, the alternative tax—a maximum of 25 percent on net long-term capital gains—is available and is more favorable to use when an individual's marginal tax rate exceeds 50 percent. For married couples filing a joint return, the alternative tax is more favorable when taxable income is greater than $52,000. For single persons, the alternative tax is more favorable when taxable income exceeds $26,000.

Problem.—In recent years, many high-income taxpayers have planned to take advantage of the lower 25-percent alternative capital gains tax and have revised 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 rate. A taxpayer with a 70-percent marginal rate, for example, in effect includes only 36 percent of his net long-term capital gain in his income. As a result, the portion of a taxpayer's capital gain income subject to tax varies according to his marginal tax rate—the higher the tax rate, the smaller the portion of the gain which is taxed. The alternative capital gains rate, therefore, appears to be at variance with the intent of the progressive rate structure to tax individuals according to their ability to pay. The effect of the alternative capital gains tax on the effective rate of tax is shown in the table presented below in which the returns are classified by adjusted gross income in the case of those which are estimated to use the alternative capital gains tax in 1969.

This table also indicates the rates which would apply in each adjusted gross income category if the alternative capital gains rate were not available (the House bill) and under the Finance Committee cut back.

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

Finance Committee decision.—The House bill would have repealed the alternative capital gains rate for noncorporate taxpayers effective with respect to sales and other dispositions after July 25, 1969. As a result, after that date noncorporate taxpayers would have included one-half of their net long-term capital gains in income without regard to their tax rate bracket. Given the rate schedules in the House bill and the committee amendments, this would have meant a top

alternative capital gains rate of 32½ percent in 1972 and subsequent years for those in the top bracket rate of 65 percent.

The committee amendments generally are in accord with the objectives of the House bill in repealing the present 25-percent alternative rate on capital gains. However, it was thought that taxpayers with relatively small amounts of capital gain should continue to be eligible for this 25-percent alternative rate. Accordingly, the committee amendments provide that single persons and married couples filing joint returns may continue to apply this alternative rate in the case of gains up to $140,000 ($70,000 for a married person filing a separate return) provided they do not have tax preference income (other than capital gains) greater than $10,000. The tax preferences referred to here are the same as those provided in the case of the minimum tax except for the exclusion of the capital gains.

The committee amendments also change the effective date of the provisions to apply to years beginning after December 31, 1969 (in lieu of applying the changes to sales or other dispositions after July 25, 1969, under the House bill). They also phase in the higher rates over a 3-year period. The present rate of 27½-percent in 1969 (including the surtax) is increased as follows:

	Percent
1970 (before applying the surtax)	28¾
1971	31
1972	32½

The committee amendments also provide that the present 25-percent capital gains tax rate (plus any surcharge) is to continue to apply in the case of binding contracts which were in effect on or before October 9, 1969. (This does not apply, however, in the case of gain from the sale of timber, or coal or iron ore royalties taxed as a capital gain under section 631 or amounts received with respect to patents under section 1235 of the code.)

In the case of installment payments received after 1969 which relate to sales made on or before October 9, 1969, the present maximum alternate rate of 25 percent, plus any surcharge, is to continue to apply to those installments received in the future. Similarly, the 25-percent rate, plus any surcharge, will continue to apply to distributions from corporations pursuant to plans of liquidation adopted prior to October 9, 1969, under which the corporation will sell its assets and distribute the proceeds to shareholders.

2. Alternative Tax Rate for Corporations

Present law.—Corporations that have an excess of net long-term capital gains over net short-term capital losses may use the "alternative tax," which taxes the entire excess net long-term capital gain at 25 percent. Since the corporate tax structure is not graduated (as is 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.

Problem.—The committee amendments reduce the availability of the alternative tax for many individuals, thereby raising their maximum capital gain rates. Accordingly, it appears appropriate to raise the corporate alternative tax rate to a greater percentage of the regular corporate tax rate. In addition, since corporations are not subject to

graduated tax rates, they usually do not encounter the problem of having bunched income, which has accrued over more than a one year period and which is taxed in one year at steeply graduated rates. This, of course, is one of the reasons for providing special tax treatment for capital gains.

Finance Committee decision.—Both the House bill and the committee amendments increase the alternative capital gains rate which is applied to a corporation's net long-term capital gains from the present 27½ percent (including the surcharge) to 30 percent.

The House bill would have made this change effective with respect to sales and other dispositions occurring after July 31, 1969. The committee amendments continue the present 27½-percent rate (including the surcharge) for the entire calendar year 1969. They provide, however, that the full 30-percent rate is not to be effective until 1971. In 1970 a special rate (halfway between the 27½ percent and the 30 percent) is to be effective; namely, a rate of 28¾ percent (including the surcharge).

The committee amendments provide that the 25-percent capital gains tax rate (plus any surcharge) is to continue to apply in the case of binding contracts which were in effect on or before October 9, 1969. (This does not apply, however, in the case of gain from the sale of timber or coal or iron ore royalties taxed as capital gain under section 631 or amounts received with respect to patents under section 1235 of the code).

In the case of installment payments received after 1969 which relate to sales made on or before October 9, 1969, the alternative rate of 25 percent (plus any surcharge) is to continue to apply to these installments received in the future.

3. Capital Losses of Individuals

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.)

When a husband and wife each have capital transactions and a joint return is filed, their respective gains and losses are treated as though they had been realized by only one taxpayer and are offset against each other. On the other hand, when both spouses have capital losses and file separate returns, each spouse is allowed to deduct up to $1,000 of net capital losses from ordinary income.

Problem.—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).

In addition, when it is more advantageous to them, married couples can file separate returns, be treated as two separate taxpayers, and be allowed to deduct up to $1,000 of capital losses from ordinary income. This treatment is permitted even though married couples are generally treated as one taxpayer. This treatment of losses tends to provide an advantage for people living in community property States because all

gains and losses from community property are attributable in equal amounts to each of the spouses by operation of community property law and, therefore, they are automatically eligible for the benefit of the double deduction. On the other hand, spouses living in noncommunity property States must have separate losses in order to claim this advantage—hence, they must either sell assets held in their joint names or each must sell his own assets. (In addition, they must have equal incomes or the loss offset may be more than offset by a difference in tax from loss of the joint return benefit as a result of this variation in income.)

Finance Committee decision.—Both the House bill and the committee amendments provide that only 50 percent of an individual's long-term capital losses may be offset against his ordinary income up to the $1,000 limit. Thus, $2,000 of losses will be required to obtain the full $1,000 deduction. (Short-term capital losses, however, will continue to be fully deductible.) In addition, 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 House bill would have applied these provisions in taxable years beginning after July 25, 1969. The committee amendments advance this date to taxable years beginning after December 31, 1969.

4. Capital Loss Carrybacks for Corporations.

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 in the case of individuals and a 5-year capital loss carryover is available in the case of corporations. No carrybacks are available either in the case of individuals or in the case of corporations. Capital losses which are carried to other years first are offset against capital gains realized in those years. In the case of individuals, any remaining losses may 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.

Problem.—In the case of regular operating losses, Congress has found in the past that a carryback of a loss was often more beneficial to a corporation than a carry forward.

A carryback results in the immediate refund of tax paid in prior years, whereas a carry forward of a loss merely holds out the prospect of a lesser tax at some time in the future. The carryback, therefore, makes cash available at the time the loss occurs and often helps to offset the disadvantages of the incurring of 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. The problem is different in the case of individuals, however, since here the capital loss in part is allowed against ordinary income.

Finance Committee decision.—The committee amendments provide a 3-year capital loss carryback for corporations. This is not available, however, for foreign expropriation capital losses for which a special 10-year carry forward (in lieu of the regular 5-year carry forward) is available under present law or for losses incurred by subchapter S corporations. Present law provides that taxpayers filing for refunds

with respect to net operating loss carrybacks may obtain a so-called "quickie" refund under which the refund is made to them after only a preliminary check on the appropriateness of the refund. Subsequently, a full examination is made of the refund under the regular auditing processes. The "quickie" refund in this case 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 in the same manner as in the case of net operating loss carrybacks.

This amendment applies to capital losses sustained in taxable years beginning after December 31, 1969.

There is no comparable provision in the House bill.

5. Collections of Letters, Memorandums, Etc.

Present law.—Present law excludes copyrights and literary, musical, or artistic compositions (or similar property) 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 for the individual) are not excluded from the definition of a capital asset, gains from the sale of such property are accorded capital gains treatment.

Problem.—The rationale underlying the present law treatment of artistic works and similar property in the hands of the person who created them, in effect, is that the person is engaged in the business of creating the artistic work or similar property. In view of this, the gain arising from the sale of the property is treated as ordinary income, rather than as a gain from the sale of a capital asset.

It is difficult to see why this treatment should not extend to collections of letters, memorandums, etc., created by the person or prepared for or given to him. In the one case, a person who writes a book and then sells it is treated as receiving ordinary income on the sale of the product of his personal efforts; in the other 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 his personal efforts.

Finance Committee decision.—Both the House bill and the committee amendments provide that letters, memorandums, and similar property (or collections thereof) are not to be treated as capital assets, if they are held by the 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 such a taxpayer). 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 taxed as ordinary income rather than capital gains. This also means, as a result of other changes in the bill in the charitable contributions deductions, that where such letters, memorandums or similar property are given to charitable organizations and a deduction claimed, the appreciation in value of these letters, etc., will be excluded from the amount of the deduction.

The House bill would have made this amendment effective with respect to sales and other dispositions of property occurring after July 25, 1969. The committee amendments make this provision applicable to sales or other dispositions of these papers occurring on or after January 1, 1969.

6. Holding Period of Capital Assets

Present law.—Capital gains on assets held longer than 6 months are considered long-term gains. In the case of individuals, 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 maximum rate of 25 percent (30 percent under the bill) rather than at the regular 48-percent corporate rate.

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.

Finance Committee decision.—The Finance Committee restored the 6-month holding period of present law.

7. Total Distributions From Qualified Pension, Etc., Plans

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 to, and the earnings of, a tax-exempt trust generally are not taxed to the employee until the amount credited to his account are distributed or "made available" to him. Retirement benefits generally are taxed as ordinary income under the annuity rules when the amounts are distributed, to the extent they exceed the amounts contributed by the employee. Thus, employee contributions to a pension, etc., fund are not taxed when received since these amounts were contributed from after-tax dollars of the employee.

An exception to the general rule of ordinary income treatment of pension benefits, however, provides that if an employee (not including self-employed persons) receives his total accrued benefits in a distribution within 1 taxable year on account of separation from service or death, the distribution is taxed as a capital gain, rather than ordinary income.

If part or all of this total distribution consists of employer securities, the employee is not taxed on the net unrealized appreciation in the securities at the time of distribution, but instead only when the stock is subsequently sold by the employee. The employee is taxed at the time of distribution only on the portion of the employer securities attributable to the employer's cost at the time of the contribution to the trust. Furthermore, this portion is taxed at the long-term capital gains rate, rather than at ordinary income rates.

Problem.—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 1 taxable year which had accrued over several years.

The capital gains treatment afforded lump-sum distributions from qualified pension plans allows employees to receive substantial amounts of deferred compensation at a much more favorable tax rate than other

compensation received for services rendered. Moreover, 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 $800,000 and over have been made.

Finance Committee decision.—The House bill limits the extent to which capital gains treatment is to be allowed for lump-sum distributions from qualified employees' trusts. Capital gains treatment under the House bill is limited to the taxable portion of the distribution in excess of employer contributions which accrued during plan years beginning after 1969. The effect of this is to treat as ordinary income the amounts attributable to these employer contributions accruing after 1969. This treatment applies to employer contributions of employer's securities as well as where other amounts are contributed by the employer to the plan. The committee amendments adopt this portion of the House provision.

The House bill also would have provided a special 5-year "forward" averaging with respect to the amounts to be treated as ordinary income. Under this procedure, the taxpayer would compute the increase in tax resulting from including one-fifth of the portion of the distribution to which ordinary income tax is to apply in his gross income for the year in which the distribution is made. The tax on this one-fifth is then multiplied by 5 to obtain his tax liability on the entire ordinary income portion. The House bill would have further provided that the taxpayer could receive a partial refund of his tax on the ordinary income portion at the end of the 5-year period by adding one-fifth of the ordinary income portion into gross income in each of the 5 taxable years. If the tax determined in this manner resulted in a lower tax than that previously paid, the taxpayer would be entitled to a refund.

To simplify the computations involved for the taxpayers, the committee amendments provide a substitute for the 5-year "forward" averaging provision. Under the committee amendments, there would be one determination of the tax on the ordinary income portion of the distribution with no subsequent recomputations or refunds. In this computation, the taxpayer would not take into account any compensation received from his employer during the year of the lump-sum distribution in determining the tax on the one-fifth. In addition, in determining this tax on the one-fifth, the capital gains portion of the lump-sum distribution also would not be taken into account. These two provisions avoid placing the taxpayer in a higher tax bracket in the year of receipt because of the lump-sum distribution and salary income received during his final year of employment. This avoids the need for a refund procedure to recompute the tax liability on the ordinary income portion after 5 years.

8. Sales of Life Estates, Etc.

Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, by bequest, or through inheritance, the basis of the property is divided between the life estate and the remainder. The owner of the life interest is not permitted to deduct any portion of his basis over the life of his interest and thereby to reduce for tax purposes the amount of income he receives from his interest. 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 is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

Problem.—This treatment of life estates has the effect of allowing a large portion, and in some cases, almost all of the income from a life estate or similar interest to avoid taxation in those situations where the life tenant sells his interest. This is because the life tenant is not taxed on his income to the extent of his basis and, in addition, the purchaser of this interest is not taxed on most of the income from it because he is allowed to reduce that income by amortization deductions for the purchase price which he pays for the interest. 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.

Finance Committee decision.—The House bill and the committee amendments 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.

Neither version of the bill, however, changes present law where a life interest is disposed of as a part of a single transaction in which the entire fee interest is transferred to any other persons. This occurs, for example, where a life tenant and remainderman join in the sale of the entire property interest. In such a case the gain realized by the life tenant is to be measured by the excess of the proceeds received on the sale over his basis for his interest.

The House bill would apply to sales or other dispositions after July 25, 1969. The committee amendment moves this effective date up to October 9, 1969.

9. Certain Casualty Losses Under Section 1231

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 types of property subject to this provision generally are depreciable property and real estate used in a trade or business.

An exception to this general provision is provided for uninsured losses resulting from casualty or theft in the case of property used in a trade or business (or capital assets held for the production of income). These uninsured losses are deductible in full against ordinary income rather than being required to be netted with other gains and losses under section 1231.

Problem.—The exception to the general section 1231 rule has led to anomalous results. 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 uninsured loss 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, the gain and loss do not have to be netted under section 1231. On the other hand, the netting is required where the business taxpayer only partially (perhaps 5 percent) insures a business property.

Finance Committee decision.—The House bill and the committee amendments modify the treatment of casualty losses and casualty gains (under sec. 1231) to provide that casualty (or theft) losses on depreciable property and real estate used in a trade or business and on

capital assets held for the production of income 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 is to be treated as an ordinary loss (without regard to whether there may be noncasualty gains coming under section 1231). On the other hand, if the casualty gains exceed the casualty losses then the net gain is to be treated as a section 1231 gain which must then be consolidated with other gains and losses under section 1231.

Under the bill, the rule described above applies where the casualty property is uninsured, partially insured, or totally insured. Although the House intended that casualty losses and casualty gains on capital assets which are personal assets (such as a personal residence or a non-business automobile) were to be subject to this special rule, they were unintentionally omitted. The committee amendments specifically include personal assets in this netting of casualty gains and casualty losses.

Both versions of the bill also clarify the fact that uninsured casualty losses on personal assets are subject to the basic section 1231 provisions.

The House provision would have applied to taxable years beginning after July 25, 1969. The committee amendments move this effective date up to December 31, 1969.

10. Transfers of Franchises, Trademarks, and Trade Names

Present law.—Questions have arisen under present law as to whether the transfer of a franchise is to be treated as an outright sale or as a mere license, and whether the franchisors are selling franchises in the ordinary course of business. Depending upon how these questions are resolved, the franchisor will receive ordinary income or capital gains treatment on the gain he realizes on the transfer of a franchise. A similar situation exists in the case of trademarks and trade names. At present, these problems must be resolved under general tax principles, and this has produced different results; i.e., capital gains in some situations and ordinary income treatment in others, despite factual similarities in the interests in the franchises (or trademarks or trade names) transferred.

Problem.—On several occasions the Tax Court has held that the transfer of franchises was not a sale for tax purposes and that all gains therefrom were to be taxed as ordinary income. This position of the Tax Court has been accepted generally by two circuit courts of appeals; however, three other circuit courts have found sales to exist in similar transactions and have allowed franchisors capital gains treatment. Since present law does not specifically deal with the tax treatment of the transfer of a franchise, and since this has resulted in a considerable diversity of opinion among the courts as to whether the transfer of a franchise constitutes a license or a sale (and whether part or all of a sale of a franchise constitutes the sale of a capital asset) there appears to be a need for legislation in this area. A similar situation exists in the transfer of trademarks and trade names.

Finance Committee decision.—The House bill and the committee amendments deny a franchisor capital gains treatment on the transfer of a franchise if he retains any significant power, right or continuing interest with respect to the subject matter of the franchise. In the event the franchise agreement includes significant rights or restrictions which are subject to the franchisor's approval on a continuing basis, this power to exercise continuing active operational

control over the franchise constitutes the franchisor's retention of a significant power, right, or continuing interest. Moreover, if the franchisor's conduct constitutes participation in the commercial or economic activities of the franchise then this too will be regarded as a retention of a significant power, right or continuing interest.

The Finance Committee amendments made more specific the rules of the House bill by providing the following:

(1) The committee amendments provide that included in the concept of retaining a "significant power, right, or continuing interest" (i.e., rights having the effect of giving the franchisor effective control of the operations of the franchise) are situations where the franchisor can require the franchisee to sell or advertise only the product or the services of the franchisor, the right to set the standards of quality of the products used or sold and of the equipment and facilities used, and a requirement that the franchisee purchase substantially all of its products or equipment from the franchisor. These conditions would not include, however, rights which can be justified as reasonably necessary for the protection of the franchisor (e.g., a security interest, the right to terminate for nonperformance, and the right to inspect the franchisee's books).

(2) Franchise agreements frequently provide for the franchisee to pay the franchisor an initial payment (a lump sum or fixed amount payable in installments) as well as additional payments contingent upon the use, disposition, or productivity of the subject matter of the franchise. (These contingent payments are customarily measured by the franchisee's gross sales or are based upon some form of sales unit.) The payment by a franchisee to a franchisor of a lump sum or a fixed amount, taken by itself, suggests a capital transaction. On the other hand, a transaction providing only for contingent payments suggests the retention by the franchisor of a significant power, right, or continuing interest in the subject matter of the franchise. To resolve the problem where there is a combined method of payment—an initial lump-sum payment or installment payments plus contingent payments—the committee amendments provide that the term "significant power, right, or continuing interest" (in determining whether the transfer of the franchise is a sale of a capital asset or a license arrangement) is to include a right to contingent payments where they constitute a substantial element under the parties' agreement. Even where the contingent payments are small, however, they are to be treated as ordinary income to the franchisor. In such cases, the franchisee would be allowed to deduct these contingent payments currently.

(3) The committee amendments also provide rules with respect to initial payments (including a lump sum or fixed amount payable in installments) made by a franchisee to a franchisor, determining the treatment to be accorded these payments based upon whether the agreement constitutes a sale or a license. Where the transfer constitutes a sale, the franchisor is to continue to treat an initial payment as proceeds from a sale; that is, the transfer is to give rise to a capital transaction (except in the case of a dealer). In such a case, the franchisee, if he has purchased an intangible asset without an ascertainable useful life, is to continue to be treated as under present law, and thereby not to be entitled to depreciation or amortization deductions for the payment made to the franchisor. Where the franchise agreement constitutes a license, however, the franchisor is to treat an initial payment as

ordinary income and the franchisee is to treat it as a deductible expense over the period to which the payment is attributable but, in no event, over more than 10 years.

The committee decided to exclude transfers of a franchise to engage in professional sports from the application of this provision.

The rule provided by the House version of the bill would not apply with respect to amount received or accrued in connection with the transfer of a franchise which is attributable to the transfer of all substantial rights of a patent, trademark, or trade name, to the extent the amounts separately identified are reasonable in amount. The committee amendments, however, deleted these exceptions, since patents are treated specifically in section 1235 of the code and the committee amendments also apply the general franchise rules to transfers of trademarks and trade names.

The House provision would apply to transfers made after July 25, 1969. The committee amendments move this date up to December 31, 1969, except that transferees may elect to treat payments made by them in taxable years ending after December 31, 1969, pursuant to transfers before that date, as subject to the new rules for deduction purposes only.

R. REAL ESTATE DEPRECIATION

Present law.—Under present law, the first user may take depreciation allowances for real property under the double-declining-balance method or the sum-of-the-years-digits method. These rapid depreciation methods generally permit large portions of an asset's total basis to be deducted in the early years of the asset's useful life. A subsequent owner is permitted to use the 150-percent declining-balance-method, which also provides more rapid depreciation than straight line in the early years.

Net gains on sales of real property used in a trade or business are, with certain exceptions, taxed as capital gains and losses are treated as ordinary losses. Gain on the sale of buildings is taxed as ordinary income to the extent of depreciation taken on that property after December 31, 1963, if the property has been held not more than 12 months. If the property has been held over 12 months, the excess depreciation over straight line depreciation is "recaptured" as ordinary income and that amount is reduced after 20 months, at the rate of 1 percent per month, until 120 months, after which nothing is recaptured.

Problem.—The present tax treatment of real estate has been used by some high-income individuals as a tax shelter to escape payment of tax on substantial portions of their economic income. The rapid depreciation methods now allowed make it possible for taxpayers to deduct amounts in excess of those required to service the mortgage during the early life of the property. Moreover, because accelerated depreciation usually produces a deduction in excess of the actual decline in the usefulness of property, economically profitable real estate operations are normally converted into substantial tax losses, sheltering from income tax such economic profits 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 can be treated as a capital gain to the extent that the recapture provisions do not apply. By holding the property for 10 years

before sale, moreover, the taxpayer can arrange to have all the gain resulting from excess depreciation (which was offset against ordinary income) taxed as a capital gain without the recapture provisions coming into play. The tax advantages from such operations increase as a taxpayer's income moves into the higher tax brackets.

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.

In addition to the tax shelter aspect of the present depreciation allowances in the case of individuals, problems have also been raised as to whether the present allowance constitutes an undue incentive for commercial and industrial construction.

Finance Committee decision.—The House bill and committee amendments revise real estate depreciation allowances to limit the opportunities to use the present treatment as a tax shelter and yet, at the same time, to maintain tax incentives to build housing where the need is great.

Under the bill and committee amendments, the most accelerated methods of real estate depreciation (the 200-percent declining balance and sum-of-the-years digit methods) are limited to new residential housing. To qualify for this accelerated depreciation, at least 80 percent of the income from the building must be derived from rentals of residential units.

Other new real estate, including commercial and industrial buildings, under both the House bill and committee amendments, is to be limited to the 150-percent declining balance depreciation method.

In the case of used buildings (including housing), depreciation on future acquisitions is to be limited to straight line depreciation.

A special 5-year amortization deduction is provided in the case of expenditures in the future for the rehabilitation of buildings for low-cost rental housing. This rapid amortization is to be available only for low-income rental housing where the dwelling units are held for occupancy by families and individuals of low or moderate income as determined in a manner consistent with the policies of the Housing and Urban Development Act of 1968. To qualify for this treatment, the aggregate rehabilitation as to any housing may not exceed $15,000 per dwelling unit and the sum of the rehabilitation expenditures (over a 2-year period) must exceed $3,000 per dwelling unit. The committee amendments provide that the special 5-year amortization deduction for rehabilitation expenditures is to apply only with respect to such expenditures made before December 31, 1974. This termination date is designed to give Congress an opportunity at that time to evaluate the effectiveness of the program in achieving its objective.

The House bill and the committee amendments also provide that where depreciable real estate is sold in the future 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. The committee, while accepting this provision, modified it to provide that in the case of sale of new residential housing there is to be a percentage reduction in the amount of excess depreciation recaptured. Under the committee amendments, the full excess of accelerated over straight-line depreciation is to be recaptured on the sales of such property within the first 10 years. After the first

10 years, the percentage reduction in this excess depreciation subject to recapture is to be 1 percent a month. This means that if the property is sold after the fourth month of the 19th year of the taxpayer's holding period, there is to be no recapture of excess depreciation in the case of the sale of new residential housing under the committee amendments.

The committee amendments provide that the recapture rules described above are not to apply in the case of federally assisted projects (such as the so-called FHA 221(d)(3) and FHA 236 programs) or to other publicly assisted housing programs under which the return to the investor is limited on a comparable basis. These Federal programs presently provide only a 6-percent rate of return to investors and, therefore, the favorable tax treatment presently provided accounts for much of the attractiveness of these programs. The present recapture rules in the case of these projects provide for a recapture of the excess depreciation in full only if the sale occurs in the first 20 months. If the sale occurs after that time, the excess depreciation over straight line which is recaptured is reduced by 1 percent a month until 120 months after which no recapture applies. The committee amendments continue these present rules but provide that these more generous recapture rules are to apply only in respect to property constructed, reconstructed, or acquired before January 1, 1975. This is designed to give the Congress an opportunity at that time to evaluate the effectiveness of this tax-incentive provision.

The committee also modified the House bill to allow accelerated depreciation with respect to a building yet to be constructed providing that the taxpayer had filed with the appropriate local government 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 the initial application was filed.

In the case of U.S. persons deriving income from real estate abroad which nevertheless may be subject to U.S. tax, the committee decided that the fast depreciation methods described above are to be available in these cases for housing for purposes of the computation of U.S. tax in any situations where the foreign country also allows a comparable fast depreciation method but only to the extent of the accelerated rates under U.S. law or under the laws of the foreign country, whichever is the lesser.

The changes in depreciation methods as to both new and used property with respect to residential housing and other construction are not to apply to construction which began before July 25, 1969, or where there was a written contract to construct or sell the building before that date. The House bill would have applied the binding contract rule only in the case of new construction. In addition, the House bill would have applied the new recapture rules to all depreciation attributable to periods after July 24, 1969. The committee amendments apply the new recapture rules to depreciation attributable to periods after December 31, 1969. In addition, the existing recapture rules are to be applied where the sale of the property was subject to a binding contract in existence prior to October 9, 1969, even though the transfer takes place after this date.

S. SUBCHAPTER S CORPORATIONS

Present law.—Subchapter S of the Internal Revenue Code was enacted in 1958 to provide tax relief for small business corporations (those with 10 or fewer shareholders) by allowing them to elect not to be taxed as a corporation, but instead to have the income or loss of the corporation taxed directly to the shareholders in a pattern roughly similar to that of partnership taxation. These provisions do not deal with employee retirement plans; consequently, subchapter S corporations may establish corporate retirement plans which are no different from plans established by other corporations and thus may include employees who are also shareholders of the corporation.

Prior to 1962, self-employed persons (proprietors and partners) were not able to establish such plans to benefit themselves. In 1962, however, Congress enacted the Self-Employed Individuals 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 employees 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.

Problem.—The H.R. 10 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 while at the same time retaining many of the benefits of tax treatment as a partnership. 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 plans.

Finance Committee decision.—Both the House bill and the committee amendments provide limitations similar to those contained in the retirement plans for individuals (the so-called H.R. 10 type plans) with respect to contributions made by subchapter S corporations to the retirement plans for individuals who are "shareholder employees"; that is, employees or officers who own more than 5 percent of the corporation's stock. Under both versions of the bill, a shareholder-employee must include in his income the contributions made by the corporation under a qualified plan on his behalf to the extent contributions exceed 10 percent of his salary or $2,500, whichever is less.

This provision applies to taxable years of subchapter S corporations beginning after 1969.

T. TAX TREATMENT OF STATE AND MUNICIPAL BONDS

1. Election to Issue Taxable Bonds With Interest Subsidy

Present law.—Interest payments on obligations of State and local governments generally are exempt from Federal income tax, an exemption that has been provided ever since the Federal income tax was adopted in 1913.

Problem.—It is understood that the 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 exempt

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 of the Federal Government was $1.8 billion. However, because of concern that any action with respect to State and municipal bonds can 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, the committee concluded that any action having an impact on State and local government bond prices would be particularly unfortunate in the present circumstances.

Finance Committee decision.—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 Finance Committee amendments deleted this provision from the bill. However, the committee bill requires that every person who receives or accrues interest on tax-exempt State and local government bonds 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.

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.

Problem.—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. In such cases, it would appear that the State or local bonds were issued to derive arbitrage income from the investment of funds and not to carry on a governmental function.

Finance Committee decision.—The House bill made provision for the taxation of arbitrage bonds issued by State or local governments. The 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. This provision was to apply to obligations issued after July 11, 1969.

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 issues where part or 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 for a temporary period be invested in securities or other obligations 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 to the satisfaction of the Treasury Department that a higher amount is necessary.

The committee amendments are effective with respect to obligations issued after October 9, 1969.

U. EXTENSION OF TAX SURCHARGE AND EXCISE TAXES

1. Extension of Tax Surcharge at 5-Percent Annual Rate for First Half of 1970.

Present law.—The Revenue and Expenditure Control Act of 1968 adopted a 10-percent surcharge on the tax liabilities of individuals and business corporations in order to dampen inflationary pressures and keep the economy under control. 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.

Problem.—The extension of the surcharge until the end of calendar year 1969 provided by H.R. 9951 will help combat the inflationary pressures which have remained strong. However, these inflationary pressures are still such that the committee believes an extension of the surcharge (at a lower rate) through the first half of 1970 is necessary in order to finish the job of bringing the economy under control. The gross national product is still rising; the consumer price index and the wholesale price index have risen at annual rates of 5.6 and 3.6 percent, respectively, since the end of last year; and our financial and money markets are showing marked signs of strain.

Finance Committee decision.—Both the House bill and the committee amendments, in effect, provide that the surcharge on the tax liabilities of individuals and corporations which, under present law, is scheduled to expire on December 31, 1969, is to be continued at a 5 percent annual rate for the period from January 1, 1970, until June 30, 1970. For a calendar year taxpayer, the surcharge is applied for the entire year rather than for one-half the year which means that insofar as tax returns are concerned those for calendar 1970 will show a 2½-percent surcharge.[1] For withholding tax purposes, however, the surcharge is to be taken into account at a 5-percent rate with respect to wages and salaries paid in the first half of the calendar year. In the second half of the year, insofar as withholding is concerned, no surcharge is to be imposed.

A conforming amendment is also made which relates 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 the foreign subsidiaries in its own income.

The above provisions under the House bill and the committee amendments apply to taxable years ending after December 31, 1969, and beginning before July 1, 1970.

2. Continuation of Excise Taxes on Communication Services and Automobiles

Present law.—The excise tax on passenger automobiles presently is 7 percent and the excise tax on local and toll telephone services and teletypewriter exchange services presently is 10 percent. Both rates are scheduled to decline to 5 percent on January 1, 1970, 3 percent on January 1, 1971, 1 percent on January 1, 1972, and to be repealed on January 1, 1973.

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[1] In the case of a fiscal year taxpayer the surcharge is at an annual rate of 10 percent for the period ending December 31, 1969, and at an annual rate of 5 percent for the period beginning January 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.

Problem.—It appears inappropriate to reduce these excise taxes during a period of continuing inflationary pressures when the Federal Government has imposed an income tax surcharge and is applying other forms of fiscal and monetary restraints to control the inflationary pressures.

Finance Committee decision.—The House bill and the committee amendments postpone for one year the scheduled reduction 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 one year. Under both versions of the bill the scheduled rates for the excise taxes on passenger automobiles and communications services are as follows:

Year	Rate (percent)	
	Automobiles	Communications services
1970	7	10
1971	5	5
1972	3	3
1973	1	1
1974	[1]	[1]

[1] Tax is repealed.

These provisions become effective on January 1, 1970.

V. REPEAL OF THE INVESTMENT CREDIT

Present law.—Present law provides a 7-percent tax credit (3 percent for public utility property) for qualified investment in: (1) tangible personal property; (2) other property (not including buildings and structural components) which is an integral part of a manufacturing or production or research or storage facility; and (3) elevators and escalators.

To qualify, the property must be depreciable and have a useful life of four years or more. New property fully qualifies for the credit. Up to $50,000 of used property can be taken into account in any year.

Property with a useful life of from four to six years qualifies for the credit to the extent of one-third of its cost. Property with a useful life of six to eight years qualifies to the extent of two-thirds of the investment. If the property has a useful life of eight 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 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 three prior years and carried forward to the succeeding 7 taxable years.

Problem.—The investment credit does not appear to be suited to present conditions. The credit was designed to provide a tax inducement for businessmen to modernize their equipment and expand productive capacity. Since 1962, business has invested $400 billion in new plant and equipment, and it would appear that there is no reason to grant a tax inducement for new investment now.

The current outlook is that plant and equipment expenditures will reach record levels in 1969. Such expenditures have risen from $64.1 billion in 1968 to $70.9 billion in 1969 and now are expected to rise another 8.3 percent in 1970. Much of this investment has resulted from the inflationary psychology which induces businessmen to increase plant and equipment spending beyond normal levels in an attempt to avoid higher costs in later years. In such a situation, business investment should not be stimulated. Instead, such investment should be moderated in order to contain an overactive economy and reduce inflationary pressures.

The investment credit cannot be turned on and off quickly to adjust to current economic conditions. In 1966, the credit was suspended temporarily in order to reduce the inflationary impact of large investment expenditures; but the investment credit continued to have an expansionary impact on some investments beyond the cutoff date as a result of transition provisions and carryovers of unused credits. In other cases, there was distortion in the investment process because businessmen postponed normal investments in anticipation of the time when the credit would be restored.

Finance Committee decision.—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. The two versions of the bill provide certain exceptions to this general rule, however, where the investment credit is to be available in the case of property constructed, reconstructed, erected or acquired under a binding contract entered into before April 19, 1969, or in certain other transitional situations which are discussed briefly below.

The House provision would have phased out investment credits available in 1971 through 1974 (generally those which result from binding contracts or other transition rules) by reducing the rate of the investment credit by 1/10th of one percentage point a month during this period. Under the committee amendments, however, investment credits are to be allowable in the future (where they arose from binding contracts in the past or from the application of the other transition rules) at the full 7 percent rate if the property is placed in service before 1979. No investment credits would be allowed for property placed in service after that time.

Both the House bill and the committee amendments limit the amount of unused credits from prior years which may be carried over and used in 1969 and subsequent years. Under both versions of the bill the amount of unused credits which a taxpayer can claim as a carryover to any year after 1968 cannot exceed 20 percent of the carryovers available at the end of 1968 (or any higher level of carryovers available in any subsequent year).

The 20 percent limitation on the use of carryovers is in addition to the general 50 percent limitation (the extent to which the investment credit can reduce tax liability). In determining the years in which the carryovers of investment credits are available, the House bill would have retained the present length of the carryover period, namely, three years back and seven years forward. The committee amendments, however, provide an additional three-year carryforward period for unused investment credits to the extent these unused credits cannot be used in a year solely because of the special 20 percent limitation.

As indicated above, the investment credit continues to be available under the House bill, and under the committee amendments, not only where the construction commenced, or the acquisition occurred, before April 19, 1969, but also where property is constructed (reconstructed or erected) or acquired after that date but pursuant to a contract which was binding on the taxpayer on April 18, and at all times thereafter. This applies only to contracts where the construction or acquisition of property is itself the subject matter of the contract and does not apply to contracts with persons other than a builder or supplier where the taxpayer becomes obligated to construct or acquire property; to some extent third-party situations are covered under a provision described below.

In addition to the binding contract rule, the House bill and the committee amendments contain a series of other transitional rules under which the investment credit will continue to be available although the actual construction or acquisition occurred after that date. These rules are summarized as follows:

(1) Both versions of the bill contain an "equipped building rule" which provides that where construction of a building began before April 19, 1969, and the cost of the building plus machinery and equipment which had been ordered for it before that date 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. The equipped building rule covers not only machinery and equipment to be used in the building but also incidental machinery, equipment and structures adjacent to the building and necessary to the planned use of the building. This rule applies where the entire project was planned before April 19, 1969, and more than 50 percent of the cost of the building, equipment and machinery was attributable to property on which construction began before April 19 or which was acquired or under contract binding before that time.

(2) A plant facility rule (covering cases where the facility is not housed in a building) is also provided in both versions of the bill. This provides that the investment credit is to be available where under a plan in existence on April 18, the taxpayer constructed a plant facility and more than 50 percent of the cost of the facility is attributable to property the construction of which began before April 19 or to property which was acquired by the taxpayer before that date. In such cases the investment credit is to be available with respect to the entire plant facility. Under the plant facility rule, the investment credit is also available where construction on the facility began before April 19, at the site of the plant facility. In addition, where a certificate of convenience and necessity was issued before April 19 by a Federal regulatory agency with respect to what would otherwise be two or more plant facilities, these may, under the rule set forth above, be treated as a single facility. For this treatment to apply, 50 percent of the cost of the property making up the facilities must be attributable to property the construction of which began before April 19 or to property acquired before that date.

(3) A special machinery and equipment rule makes the investment credit available where machinery and equipment was only partially

on order or under construction on April 18. Under this rule, the investment credit will continue to be available in the case of machinery and equipment where more than 50 percent of the parts or components were on hand on April 18 or are acquired under a binding contract in effect on that date.

(4) Under the bill and committee amendments, an investment credit is also available where a person who has a pre-April 19 binding contract for property sells the property to a third person and leases it back. Under the bill and committee amendments, the credit is available where the binding contract was entered into before April 19, the property (or contract rights) involved is transferred to a third person, and a person who is a party to the binding contract retains the right to use the property under a lease. In this case, the other person succeeds to the position of the transferor with respect to the binding contract and the property. The lease can be for any term unless the lessor decides not to exercise his election to permit the lessee to claim the investment credit. In this latter case, the lease must be for a term of at least one year. Under the House bill, if the lessor retained the right to use the credit and the lessee subsequently lost the right to use the property, this would be treated as a disposition of the property by the lessor and would result in a recapture of the investment credit previously allowed to the lessor (where this occurs prior to the end of the useful life of the property used in determining the amount of the credit allowed). Under the committee amendments (which are substantially identical to the rule in the 1966 legislation temporarily suspending the investment tax credit), the application of this special recapture rule contained in the House bill is limited to situations which do not involve long-term leases. The committee amendments also extend this sale and lease back rule to situations where the property sold continues to qualify for the credit under the machinery and equipment rule rather than the binding contract rule. In addition, the committee amendments provide that a corporation which is affiliated with the seller of the property may lease the property back.

(5) The House bill and committee amendments also provide for situations where binding contracts or leases entered into before April 19 require the construction of machinery or equipment under the terms of the lease or contract arrangement even though these do not qualify under the binding contract rule summarized above. Under both versions of the bill where a binding lease or contract is in effect on April 18, the investment credit is to continue to be available in the case of this property. Where a project includes property in addition to that covered by a specific lease arrangement, this rule is to apply to the other property only if binding leases and contracts in effect on April 18 covered real property representing at least one-quarter of the entire project. The bill and committee amendments also cover cases of pre-April 19 binding contracts involving the construction or acquisition of property specified in an order of a Federal regulatory commission for which an application was filed before April 19. In these cases, the property must be used for the purpose of transporting one or more products to be purchased or sold under the contract, and one or more parties to the contract must have had commitments in existence on April 18 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 useful life of the property.

(6) The House bill and committee amendments provide that in

determining whether property is to be treated as acquired under a binding contract before April 19, certain transfers are to be disregarded. The type to be disregarded are transfers where it is appropriate for the transferee to "step into the shoes" of the transferor. These include cases where there is a transfer at death, a transfer to a corporation upon the liquidation of a subsidiary, a transfer to a controlled corporation, a transfer as a result of a tax-free corporate reorganization, a transfer to a partnership by a partner in exchange for an interest in the partnership, and a transfer by a partnership to a partner.

(7) Both versions of the bill make the investment credit available where property is acquired by a corporation which is a member of an affiliated group from another member of the group in whose hands it would qualify for the credit because of the construction, acquisition, or binding contract rules. In such a case, the property may be transferred to another member of the same group without losing the investment credit, even though that occurs after the effective date. The House bill also provides that a contract between members of an affiliated group is not to be treated as a binding contract even though it was entered into prior to April 19, 1969. The committee amendments accept this as a general rule but provide that the rule is not to apply if at all times after June 30, 1969 (and prior to the completion of the contract) the corporations no longer are members of the same affiliated group.

(8) Both versions of the bill also make the investment credit available where an ocean-going vessel (known as a mother ship) is eligible for the investment credit because of the binding contract rule (or otherwise) and this mother ship is designed to carry barges. In such cases, the House bill provides the barges are to be eligible for the investment credit, but not in a greater number than the number specified in the binding contracts with the Maritime Administration. The committee amendments modify this House provision somewhat. In the case of subsidized carriers, the credit is to be allowed for the number of barges specified in a pre-April 19 application for mortgage or construction loan insurance filed with the Secretary of Commerce. The investment credit is also to be available in the case of barges used by unsubsidized carriers where more than 50 percent of the barges the carrier plans to use otherwisc qualify under the binding contract or other transition rules.

(9) The House bill makes available the investment credit for certain new design projects where certain conditions are met. In these cases, under the House bill, the taxpayer must have undertaken before April 19 a project to produce a product of a new design, the binding contracts involved must be fixed price contracts (except for price escalation provisions relating to changes in pay rates) and the binding contracts must cover more than 60 percent of the entire production of the new design product to be delivered before 1973. This provision is applicable only where before April 19 more than 50 percent of all depreciable property required to be constructed or acquired to carry out the binding contracts either was under construction by the taxpayer, had been acquired by him, or was under a binding contract for construction or acquisition. (In applying this 50 percent test, productive items such as jigs, dies, and templates specifically designed for and only suitable for use in the manufacture

of the new design product are to be considered as property under a binding contract if they were described in written engineering and internal financial plans of the taxpayer in existence on that date.) The committee amendments modify this transition rule to provide that the fixed price binding contracts may allow for price changes due to material costs in addition to those due to pay increases, and by reducing from 60 percent to 50 percent the amount of the production of the new design products (to be delivered before 1973) which must be covered by binding contracts.

(10) The committee amendments (but not the House bill) provide an additional transitional rule under which the credit is to continue to be available in the case of property which a taxpayer must construct or acquire in order to carry out a pre-April 19, 1969, contract with a person who must take substantially all of the production from the property over its useful life. For this rule to apply, the property must be specified in a binding contract or must be extractive property with respect to which a series of special requirements are satisfied.

(11) The committee amendments (but not the House bill) provide that where a corporation purchases substantially all of another corporation's assets pursuant to a pre-April 19 binding contract, the purchasing corporation can "step into the shoes" of the other corporation for purposes of obtaining an investment credit with respect to its property and contracts.

(12) The committee amendments (but not the House bill) also include cases where under a binding lease or contract to lease entered into before April 19, a lessor or lessee is obligated to construct or acquire property specified in documents related to the lease or contract which were filed with a Federal regulatory agency before April 19. The property constructed or acquired by the lessor or lessee in such a case is to be eligible for the investment credit. A lease which is treated as a financing arrangement for other tax purposes will continue to be treated as a lease for purposes of this amendment.

(13) The committee amendments (but not the House bill) also make the investment credit available where the site of a plant facility was acquired before April 19 for the purpose of constructing a refinery and substantial expenditures for the acquisition of a pipeline in connection with the refinery occurred before April 19 and within one year after the date of acquisition of the plant site, the taxpayer commenced construction of the refinery. The investment credit is made available in such a case by considering the date of acquisition of the plant site as the date on which the construction or erection of the refinery commenced.

Other amendments made by the committee provide that recapture of investment credit upon early disposition of property is not to occur to the extent that the taxpayer replaces such property within a 6-month period after the disposition. An investment credit is not allowed in such circumstances, however, with respect to the replacement property. Relief from interest and penalties on payment of estimated tax is allowed where this results from understatement of tax because of the repeal of the credit.

W. AMORTIZATION OF POLLUTION CONTROL FACILITIES

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 generally eligible for the investment credit.

Problem.—There is a present need for industry to install facilities that will remove pollutants and contaminants from air and water discharged after use in production processes. Since termination of the investment credit will remove to some extent the financial offsets to the costs of these facilities, an alternative form of incentive may be viewed as desirable.

Finance Committee decision.—Under the House bill, a taxpayer would be allowed to amortize any certified pollution control facility over a period of 60 months. The amortization deduction would replace the depreciation deduction, but the additional first-year 20 percent depreciation allowance would still be available.

The committee amendments continue the concept of the House bill but limit the amortization deduction to pollution control facilities added to plants which were in operation on December 31, 1968. 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.

Under the House bill, certified pollution control facilities generally are defined as that part of any 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, waste or heat and which is appropriately certified. The committee amendments provide that the definition of an eligible pollution control facility is to exclude facilities which serve any function other than pollution abatement. Moreover, they are not to include facilities that only diffuse the pollution as distinct from abating pollution. Thus, the amortization treatment will only be available in the case of installations which prevent or minimize the direct release of pollutants into the air or water in the course of manufacturing operations. Facilities which remove elements from fuel that would be released as pollutants when the fuel is burned would not be eligible for the amortization deductions.

Under the House bill and the committee amendments the amortization deduction is to be available only with respect to pollution control facilities which are certified by the appropriate State and Federal authorities. Under this requirement, it is necessary for the State authority to certify to the Federal authority that the facility has

been constructed or acquired in conformity with a State program or requirements regarding the abatement or control of water or air pollution or contamination. Under the House provision, it is also necessary for the Federal authority to certify to the Treasury Department that the facility meets minimum performance standards (which must be promulgated by the Federal authority from time to time and which must take technological advances into account and specify the tolerance for such pollutants and contaminants as is appropriate); that it was in compliance with the applicable regulations of the Federal agencies; and that its operation was in furtherance of the general policies of the United States for cooperation with the States in the prevention and abatement of water and air pollution. Under the committee amendments, the Federal certifying authorities are not to establish national effluent standards for water or emission standards for air but rather are to set general guidelines for the standards to be specified by the States.

The committee provided that the 5-year amortization deduction for air and water pollution control facilities is only to apply to those placed in service before January 1, 1975.

The amendments made by this provision under both the House bill and the committee amendments apply to taxable years ending after 1968.

X. AMORTIZATION OF CERTAIN RAILROAD ROLLING STOCK, ETC.

Present law.—An investment credit is generally allowable with respect to railroad rolling stock. Under present depreciation guidelines, the useful life of rolling stock is 14 years.

Problem.—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, it appears that an alternative form of incentive to encourage continuation of the present level of investment is needed. It is more appropriate to permit a rapid recovery of the costs involved, however, than to permit a return of more than total costs.

Finance Committee decision.—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 provision.

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. This applies to rolling stock acquired (or constructed) after January 1, 1970. In addition, rolling stock acquired (or constructed) during 1969 is to be eligible for 4-year amortization to the extent of any unrecovered costs as of January 1, 1970. On January 1, 1973, the Secretary of the Treasury is to issue regulations indicating particular classes of cars or locomotives which are not in short supply. Rolling stock in these specific classes of cars or locomotives which is placed in service from that time on will not 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 railroads, switching and terminal companies all of whose stock is owned by railroads and rolling stock of lessors who lease to railroads. This would include, for example, the Pacific Fruit Express and Fruit Growers Express Companies. The 5- (or 4-) year amortization provision is not available, however, in the case of rolling stock owned and used by companies other than railroads or rolling stock leased to companies other than railroads.

In addition, for purposes of the amortization provision, property placed in service at any time during 1970 is to be presumed to be placed in service on December 31, 1969. For subsequent years, the question of when the rolling stock is placed in service will depend upon the depreciation convention generally followed by the taxpayer.

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 regulations with respect to depreciation. 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 of the guideline lives.

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 facilities 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 need for 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 facilities 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, the committee amendments will treat the cost of repairs 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. This is not to be considered as a guideline, however, with respect to the repair of any other types of transportation equipment 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 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 presumed to 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.

Y. ADJUSTMENT OF TAX BURDEN FOR INDIVIDUALS

1. Increase in Standard Deduction

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).

Problem.—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 ot 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.

Finance Committee decision.—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.

2. Low-Income Allowance

Present law.—The minimum standard deduction is $200 plus $100 for each personal exemption up to a total of $1,000.

Problem.—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.

Finance Committee decision.—Over a period of three years (two years in the House bill), the committee amendments revise the present 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 (except that this amount is to be $550 in the case of a husband and wife filing separate returns).

The new minimum standard deduction or low-income allowance consists of a "basic allowance" (the former minimum standard deduction) and an "additional allowance". The basic allowance amounts to $200 plus $100 for each personal exemption up to a total of $1,100.

The "additional allowance" for 1970 (and 1971 under the committee amendments) adds a sufficient amount to the basic allowance (in the case of families with 8 or fewer exemptions) so that the total tax-free income level apart from personal exemptions in the case of each family is $1,100. In the case of a single person, this means that there is a $300 basic allowance plus an $800 additional allowance; in the case of a family unit of 2 members, the amount added to the $400 basic allowance is $700. As the amount of the basic allowance increases (by $100 for each exemption) the additional allowance added by the bill, in order to maintain a uniform $1,100 of tax-free income per family unit, decreases by $100. As a result, the differentiation as to starting tax levels for different size family units is to be based entirely on the difference in number of $600 exemptions available to a family unit. This is approximately in accord with the analysis of poverty levels for families of different sizes made by HEW which indicates that the poverty level increases by approximately $600 above a base $1,100 amount for each additional person in a family unit.

For 1970 (and 1971 under the committee amendments), the additional allowance provided by the bill is "phased out" as the income of the taxpayer increases. In 1970, for each $2 of additional adjusted gross income above the nontaxed poverty level ($1,100 plus $600 for each exemption), the additional allowance is decreased by $1. Thus, the $800 additional allowance made available in the case of single persons gradually is eliminated as income rises above $1,700 and terminates at an income level of $3,300 (an income span of $1,600). In 1971, under the committee amendments (but not under the House bill), the additional allowance is decreased by $1 for every $15 of additional income above the non-taxable level. Thus, for a single person the reduction of the additional allowance begins at $1,700 and ends at $5,872 (above that level he would find the 14-percent standard deduction available in that year worth more than the remaining low-income allowance). In 1972 under the committee amendments and in 1971 under the House bill the phaseout no longer applies.

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 may also use the tax rates for head of household. This result is obtained by treating such an individual as if she or he were a "head of household". To qualify for this status the individual

must not file a joint return, but must maintain a household which is the principal place of 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.

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 are expected to 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.

The low income allowance with the $1 for $2 phaseout is to be effective for both the House bill and the committee amendments for taxable years beginning after December 31, 1969. Under the committee amendments, the low income allowance with the $1 for $15 phaseout is to be effective for taxable years beginning after December 31, 1970 and the low income allowance (or minimum standard deduction) without the phaseout is to become fully effective for taxable years beginning after December 31, 1971. Under the House bill the phaseout would have been completely eliminated one year earlier at the end of 1970.

3. Tax Treatment of Single Persons

Present law.—Since the Revenue Act of 1948, married couples filing joint returns 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 with 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.

Single people generally do not have a comparable income splitting privilege. As a result they pay higher taxes than married couples at the same income levels.

In 1951, a head-of-household provision was enacted to grant partial income-splitting to widows, widowers, and 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 household 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 year of death of the husband or wife.

Problem.—Under present law, the tax rates imposed on single persons are quite 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. Some difference between the rate of tax paid by single

persons and joint returns appears appropriate to reflect the additional living expenses of married taxpayers but the existing differential of as much as 41 percent (the result of income splitting) cannot be justified on this basis.

Finance Committee decision.—The Finance Committee amendments provide a new, lower, rate schedule for single persons (as well as a new regular schedule and head-of-household rate schedule). This rate schedule is designed to provide tax liability for single persons which is 17 to 20 percent above that for married couples for taxable incomes of between $14,000 and $100,000, with the maximum differential of 20 percent being reached for an income level at $20,000. (At present the difference can be as great as 40 percent.) Below $14,000, where income splitting is less beneficial the excess of single persons' rates over those of married couples gradually decrease. This is also true above $100,000 again where the benefits of income splitting become less significant. A new rate schedule is also provided for heads-of-households which is one-half way between the new rate schedule for single persons and the rate schedule for married couples. The present rate schedule for single persons is maintained for married couples filing separate returns and for estates and trusts.

The new rate schedule for single persons is a different type of approach than that taken in the House bill. Under the House bill, widows and widowers, regardless of age, and single persons age 35 and over were permitted to use the head-of-household rate schedule which provides tax liability half-way between that of the regular rate schedule used by single persons and the joint return schedule.

The House bill also would have extended the joint return privilege for surviving spouses as long as they had dependent children under age 19 or attending school or college. Under present law, they have the benefits of full income splitting only for the first two years after the death of the spouse. Under the committee amendments, they will use the head-of-household rate schedule after their joint return privilege expires (two years after the year of the spouse's death) as long as they continue to support a dependent.

The new rate schedule for single persons is effective in two stages with approximately one-third of the rate reductions taking place in 1971 and the remaining two-thirds in 1972 (as is also the case with the general rate reduction).

4. Individual Income Tax Rates

Present law.—Present law tax rates range from 14 percent to 70 percent on taxable income in excess of $100,000 for a single taxpayer and $200,000 for a joint return (see the rate schedule below).

Problem.—The present tax rates are considered by many to be too high. They take a large portion of the income from those subject to the full impact of the 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.

Finance Committee decision.—The House bill and committee amendments provide the same rate reductions, applicable in 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 of tax of 5 percent or more in all brackets. Thus, for example, the top rate is reduced from 70 percent 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. The committee amendments, however, 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 ⅓ of the rate reduction to occur in 1971 and the remaining ⅔ of it to occur in 1972. The rate schedule, under present law, under the House and Finance committee bill for 1971 and the rate schedule under both bills for 1972 is shown in the table below:

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.

The first stage of the rate reduction under both the House bill and the committee amendments is applicable for taxable years beginning after December 31, 1970, and the full reduction is made applicable for taxable years beginning after December 31, 1971. In the case of fiscal years straddling these two dates the proration formula generally applicable to rate reductions applies.

5. Collection of Income Tax at Source on Wages

Present law.—Present law provides withholding tables and a percentage withholding method which incorporates the $600 personal exemption, the minimum standard deduction, the 10 percent standard deduction, and the tax rates.

Finance Committee decision.—The House bill requires the Internal Revenue Service to prescribe, and the committee amendments include

in the bill, new withholding rates and tables incorporating: the low income allowance (with the phaseout) and the 13 percent standard deduction (with the $1,400 ceiling) for 1970; the low income allowance (with the phaseout), the 14 percent standard deduction (with a $1,700 ceiling) and the new tax rates for 1971; and the low income allowance (without the phaseout), the 15 percent standard deduction (with the $2,000 ceiling) and the fully reduced tax rates for 1972.

There are no comparable provisions in the House bill.

These provisions apply to wages paid after December 31, 1969, or the 15th day after enactment, whichever is later.

6. Provision for Flexibility in Withholding Procedures

Present law.—Under present law employers are limited in methods of computing wage withholding to the withholding tables or percentage methods specified in the code or essentially equivalent methods. They are permitted to withhold on the basis of average wages paid within a calendar quarter but present law does not permit them to use average wages over a longer period.

Problem.—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. The Internal Revenue Service has no authority to permit employers to use such methods. 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 true, for example, where wage payments vary significantly in size from one pay period to another.

Finance Committee decision.—The committee amendments permit employers to use any withholding method which results in substantially the same amount of withholding as the regular methods. The amendments also permit the employers to "annualize" wage payments for withholding purposes. In addition, the bill provides that where wage payments are quite irregular, withholding can be provided on the basis of cumulative wages and cumulative withholding.

This provision is to apply for wages paid after December 31, 1969.

7. Additional Withholding Allowances for Excess Itemized Deductions

Present law.—Under present law taxpayers with estimated itemized deductions which exceed the level of deductions on which withholding is based may claim additional exemptions for withholding tax purposes for each $700 of itemized deductions above a threshold level (10 percent of the first $7,500 of estimated wages plus 17 percent of any remainder). The estimated itemized deductions in this case may be no larger than the actual itemized deductions for the prior year.

Problem.—The requirement that the estimated itemized deductions be no larger than actual deductions for the preceding year prevents the provision from operating in the first year in which a taxpayer has excess itemized deductions although their existence is clear. Problems also arise where the itemized deductions exceed the threshold level by less than $700 but nevertheless give rise to overwithholding. Moreover, with the increase in the standard deduction percentage from 10 to 15 percent, the 10 percent threshold level needs to be increased.

Finance Committee decision.—The committee's amendments eliminate the prior year's requirement for excess itemized deductions in cases where the excess itemized deductions are substantiated by a court order (such as one providing for payment of alimony) or by other evidence clearly verifying their existence. The amendments also provide that an additional withholding allowance is to be permitted for excess itemized deductions of more than $300. In addition, the amendments raise the percentage threshold for determining excess itemized deductions to conform to the higher standard deduction provided by both versions of the bill. The 10 percent applicable to the first $7,500 is increased to 15 percent and this is applied to all estimated wages and not merely the first $7,500.

There is no comparable House provision.

This provision is to be effective for taxable years beginning after December 31, 1969.

8. Certification of Nontaxability for Withholding Tax Purposes

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.

Problem.—The difficulty with the present withholding system is that individuals who work only part of a year have tax withheld on their wages even though they may have no tax liability for the entire year. This requires these employees to 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 income falls below the new levels at which tax begins. This is a substantially higher level than under present law because of the low income allowance. In addition, the withholding rates and tables are based on the assumption that the taxpayer does not have large itemized deductions (except for a special provision discussed below). As a result some taxpayers with large deductions also find themselves in a nontaxable status even though there may have been significant withholding in their cases.

Finance Committee decision.—The committee amendments provide that an individual is not to be subjected to withholding of 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.

This certification provision could relieve as many as 10 million persons from overwithholding and having to file a return only for the purpose of obtaining a refund. No comparable provision is in the House bill.

This provision will apply after April 30, 1970.

9. Withholding on Supplemental Unemployment Benefits

Present law.—Under present law supplemental unemployment benefits are not subject to withholding because they do not constitute wages or remuneration for services.

Problem.—Supplemental unemployment compensation benefits (SUB) paid by employers are generally taxable to the recipient. As a result in the absence of witholding these benefits may require a significant tax payment by the recipient.

Finance Committee decision.—The committee amendments require the payor of taxable supplemental compensation benefits to withhold Federal income tax from these payments. These are benefits paid to an employee, under a plan to which the employer is a party, which are paid because of the employee's involuntary separation from employment as a result of a reduction in force, the discontinuance of a plant or operation or similar conditions. This provision was not in the House bill.

This provision applies to such payments made after June 30, 1970.

10. Voluntary Withholding on Payments Not Defined as Wages

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 non-wage type payments even though withholding would be desirable in many cases.

Problem.—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. Where the recipient of the payment desires to have tax withheld, it is difficult to see why this should not be done.

Finance Committee decision.—The committee amendments direct the Secretary of the Treasury to issue regulations which prescribe rules 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. In the case of other payments an employer or payor would be permitted to withhold where both the employer and employee (or payor and payee) agree to such withholding.

No such provision is in the House bill.

This provision applies to such payments made after June 30, 1970.

Z. MISCELLANEOUS INCOME TAX PROVISIONS

1. Qualified Pension, Etc., Plans of Professional Corporations

Present law.—Under present law, the amounts which self-employed individuals can set aside annually on a tax-free basis for pensions in a qualified plan is limited to 10 percent of the individual's earned income not to exceed $2,500. These are the limitations imposed with respect to the so-called H.R. 10 type pension plans. In the case of employees in a corporation, however, there are no specific limitations as to the amounts which may be set aside to fund their pensions under qualified plans which do not discriminate as to benefits and coverage in favor of high-paid employees, shareholders or officers of the company.

Generally, lawyers, doctors, accountants and certain other professional groups in the past have been unable to carry on their professions

through the form of corporations because of the personal nature of their responsibility or liability for the work performed for a client or patient. In recent years, however, most States have adopted special incorporation laws which provide for what are generally known as "professional corporations." These have been used increasingly by groups of professional persons, primarily to obtain the more favorable tax treatment for pensions generally available to corporate employees. The Treasury Department in the so-called Kintner regulations held that professional corporations were not taxable as corporations partly because of the personalized responsibility or liability maintained in the case of shareholders with respect to their clients or patients. Recent court cases, however, have overturned the regulations and the Service has now acquiesced and generally recognizes these professional corporations as corporations for income tax purposes.

Problem.—Congress, in passing the H.R. 10 pension legislation, made it clear that it intended to impose limitations as to the amount which may be set aside on a tax-free basis for subsequent pension payments to self-employed persons. The formation of professional corporations, while maintaining the personal relationship between the shareholder-employee and the patient or client, has had the effect of indirectly overcoming the limitations Congress intended to impose with respect to deductible amounts which may be set aside for pensions in these cases. It is recognized that there are disparities in the treatment of self-employed individuals and corporate employees with respect to pension plans, and that this problem needs attention. These disparities are being studied and the Treasury and staffs are expected to report back with suggestions on these problems. In the meanwhile, however, it would appear inappropriate to permit what are essentially, in most respects, self-employed persons to avoid the pension limitations prescribed by Congress.

Finance Committee decision.—The committee amendments provide that shareholder-employees of a professional service organization are to include in their gross income the amounts of contributions paid on their behalf which are deductible under qualified pension, profit-sharing and stock bonus plans under the Internal Revenue Code (sec. 404(a)(1), (2) or (3)), to the extent that these amounts exceed 10 percent of the compensation received by the shareholder-employee from the organization, or $2,500, whichever is less. In addition, forfeitures allocated to the shareholder-employees' account under stock bonus or profit-sharing plans are required to be included in gross income. Where an individual is covered by plans of more than one organization, the Secretary of the Treasury or his delegate, by regulations, is to aggregate the contributions paid on his behalf in making the computations referred to above.

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, profit-sharing or stock bonus plan when the plan benefits are subsequently received by him so that the same amounts will not be taxed twice. If the rights of the shareholder-employee, 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 is permitted to deduct these amounts in the year in which his rights under the plan terminate.

The term "professional service organization" under this provision

means any corporation or association in which the beneficial ownership, or control, is limited under State or local law, or rules of professional ethics, to individuals 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 or association is engaged. This provision also covers the executor or administrator of a person 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 House provision.

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

2. Amounts Received Under Insurance Contracts for Certain Living Expenses

Present law.—Under present law, a person whose residence is damaged or destroyed by fire, storm, or other casualty, and who must temporarily find another residence while his home is being repaired must declare any insurance payments received to cover the additional living expenses as taxable income.

Problem.—In the type of situation described above, few if any persons regard the insurance payments received as "income," since the payments merely reimburse the taxpayer for a period of time for the loss of the use of property he had. In addition, taxing the insured on the reimbursement in this case means that he has had a net loss on the overall transaction.

Finance Committee decision.—The committee amendments in the case of an individual whose residence is damaged or destroyed by fire, storm or other casualty, provide that gross income does not include amounts received under an insurance contract for reimbursement for living expenses incurred by him and members of his household as the result of the loss of use or occupancy of a residence.

The amendments allow the exclusion only to the extent that the amounts received do not exceed the excess of the actual living expenses incurred by the taxpayer (for himself and members of his household) resulting from the loss of the use of the residence over the normal living expenses which would have been incurred by the taxpayer (for himself and members of his household) during this period.

No comparable provision is contained in the House bill.

This provision applies to amounts received on or after January 1, 1969.

3. Deductibility of Treble Damage Payments, Fines, Penalties, etc.

Present law.—At present, 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 grounds that the allowance of these deductions would be contrary to Federal, State or other clearly defined "public policy." This has been true, for example, in the case of certain fines.

Questions have been raised as to 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 an antitrust violation may sue for damages and recover three times the amount of economic loss established. The Internal Revenue Service has held that amounts paid or incurred in satisfaction of treble damage claims under that Act are deductible as ordinary and necessary business expenses.

Problem.—The question as to whether antitrust treble damage payments should be deductible must be viewed from the standpoint of antitrust policy and from the standpoint of tax policy. From the standpoint of antitrust policy, the basic issue is the extent to which the extra damage amounts are designed to constitute a penalty on the violator. Denying a deduction is one way of assuring that the treble damage penalties with respect to violations of the antitrust laws are not diluted by permitting them to reduce taxes otherwise paid.

From the standpoint of tax policy, there generally has been a reluctance to deny a deduction for business expenses on the grounds 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 applicable to bribes of foreign officials already suggests such a Congressional policy. At present, 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.

Finance Committee decision.—The Finance Committee bill codifies the court position that deductions are not to be allowed for fines or similar penalties paid to a government for the violation of any law.

The bill also denies deductions for three other types of expenditures: treble damage payments under the antitrust laws, deductions for bribes of public officials (whether or not foreign officials), and other unlawful bribes or "kickbacks." The codification of the rule denying deductions for payments in these situations which are deemed to violate public policy is designed to be all-inclusive. Thus, public policy generally will not be deemed to be sufficiently clearly defined in other circumstances to justify disallowance of deductions. The bill does not deal with lobbying expenditures which are already covered by an Internal Revenue Code provision (sec. 162(e)) added by section 3 of the Revenue Act of 1962.

In the case of two of the new categories, amounts are to be denied as deductions only when the expenditure or an associated expenditure arises out of a conviction in a criminal proceeding. Under the committee amendment, there would have to be a conviction in a criminal prosecution (or a plea of guilty or nolo contendere) before deductions would be denied for treble damage payments under the antitrust laws. This is also true of the provisions relating to bribes and kickbacks of other than public officials. Denial of the deduction for the payments in

these cases can be justified on the grounds that the deduction would clearly frustrate a sharply defined public policy.

In addition to denying a deduction in the case of antitrust payments and bribes and kickbacks, the amendments also cover other related payments. They also cover, for example, situations where only a few out of a series of related actions give rise to specific indictments. This policy of covering only those cases where there is a criminal conviction in a related case means that the denial of deduction will only occur in the case of "hard-core violations" where intent has been clearly proved in a criminal proceeding. It is believed, however, that illegal bribes and kickbacks with respect to public officials are in a different category and that these in all events should be denied as deductions. Such treatment is by statute already accorded bribes of or kickbacks to foreign governmental officials or employees.

In the case of treble damage payments under the antitrust laws, the denial of the deduction is limited to two-thirds of the amount paid or incurred. The remaining one-third would continue to be deductible on the grounds that it represents a restoration of the amount already owing to the other party. The denial of the deduction in this case applies not only to judgments for damages against the taxpayer under the antitrust laws but also for settlements of any actions brought under these laws.

The amendments are made applicable only with respect to amounts paid or incurred after December 31, 1969. In addition, in all cases where nondeductibility depends upon a criminal conviction, only criminal convictions after 1969 are to be taken into account. A conviction following a trial occurring after December 31, 1969, is to be treated as occurring before that date if the trial follows an appeal which resulted from a conviction following an earlier trial concluded before that date.

4. Deductibility of Accrued Vacation Pay

Present law.—Taxpayers on the accrual basis generally deduct vacation pay in the year of the accrual. Under present rules, vacation pay is considered to be accruable only after liability to a specific person has been clearly established, the amount of liability can be computed with reasonable accuracy and 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 methods.

The ruling setting forth the Treasury policy outlined above was initially made applicable to taxable years ending on or before June 30, 1955. Subsequently, the effective date of this ruling was postponed until January 1, 1959. Congress since that time has by successive actions postponed the application of this ruling for years up to taxable years ending before January 1, 1969.

Problem.—The implementation of Revenue Ruling 54-608 requires the denial of a deduction in any year where the accrual of vacation pay has not been clearly fixed with respect to specific employees. Nevertheless, it would place some taxpayers in a hardship position. The problem arises with respect to those 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. For such taxpayers to elect the ruling to go into effect would mean one year in which they receive

no deduction for vacation pay (since the current year's vacation pay deductions were 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 2-year period is needed.

Finance Committee decisions.—The committee's amendments postpone for two 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 cannot be clearly estimated or the amount computed with reasonable accuracy.

No comparable provision is contained in the House bill.

This provision is applicable for taxable years ending before January 1, 1971.

5. Banks for Cooperatives

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 of net operating losses and a 5-year carryforward.

Problem.—The problem in 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. Such situations could be provided for by a 10-year net operating loss carryback for these banks. This would appear to provide adequately for any bad debts which these banks might sustain.

Finance Committee decision.—The committee amendments provide that banks for cooperatives are to have a 10-year net operating loss carryback, in addition to the 5-year carryforward now available in the case of operating losses.

No such provision is contained in the House bill.

This amendment applies to taxable years beginning after the date of enactment of this bill.

6. Deduction of Recoveries of Antitrust Damages, etc.

Present law.—Taxpayers sometimes 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 many years after the injury was sustained. The damages are at that time includible in taxable income.

Problem.—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.

Finance Committee decision.—The committee amendments provide that in the case of losses resulting from a patent infringement, a breach of contract, a breach of fiduciary duty, or an 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 result is accomplished by providing, in effect, that the amount includible in gross income is to be the compensatory amount reduced by the amount of the unrecovered losses sustained as a result of the compensable injury.

The compensatory amount as used here means the amount of the award, settlement, or recovery reduced by the amounts paid or incurred in securing it. The unrecovered losses are the net operating losses for the year to the extent the losses are attributable to the compensable injury, reduced by the net operating losses which are allowed as offsets against income in other years. Where a net operating loss is only partially attributable to a compensable injury sustained during a year, the compensable injury portion is to be considered the portion of the loss which is last used as an offset against income in other years.

The provision applies only to recoveries for actual economic injury and not for additional amounts. In the case of treble damage recoveries under section 4 of the Clayton Act, for example, the provision applies to the ⅓ of the recovery which represents the economic injury and not to the other ⅔ of the recovery which are punitive in nature.

There is no comparable provision in the House bill.

The committee amendments apply to compensatory amounts received in taxable years beginning after December 31, 1968.

7. Corporations Using Appreciated Property to Redeem their Own Stock

Present law.—Present law (sec. 311 of the code) provides that with few exceptions gain or loss is not recognized to a corporation if it distributes property with respect to its stock either when the distribution is a dividend (sec. 301) or when it is in redemption of stock (sec. 302, 303 or 304).

Problem.—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 cash proceeds of the sale.

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 insurance companies then retire the stock they have purchased back, thereby increasing their per-share earnings, or instead of retiring stock may later use it to acquire stock of other companies.

Finance Committee decision.—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 distributed to him has appreciated in value in the hands of the distributing corporation, then

gain is to be recognized to it to the extent of this appreciation. This provision applies whether or not the redemption is classified as a dividend but it does not apply to redemptions in complete or partial liquidation of the corporation.

There is no comparable provision in the House bill.

This amendment applies to distributions after October 9, 1969, in taxable years ending after that date.

8. Reasonable Accumulations by Corporations

Present law.—Under present law, a special tax is imposed on accumulated taxable earnings of a corporation when the earnings are accumulated to save individual shareholders from the tax on dividends which would have been incurred if the earnings had been distributed. A corporation is not subject to this tax, however, to the extent the earnings are accumulated to meet the reasonable needs of the business, including the reasonably anticipated needs of the business.

Elsewhere in present law (sec. 303) provision is made for the redemption by a corporation of stock included in the estate of a deceased shareholder to the extent the amount used in such a redemption is not greater than the estate tax plus the funeral and administrative expenses. The provision applies, however, only if the stock of the corporation in question constitutes more than 35 percent of the gross estate or more than 50 percent of the taxable estate. (The section also applies in some cases where the percentage requirements are met by the stock of two or more corporations.)

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 of the corporation reduced by the percentage of stock owned by related parties. In addition, the bill provides that although generally there can be no dealings between a 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.

Problem.—Where there is a redemption 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 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. It would appear that the same question will arise when a corporation redeems stock from a foundation in order to help the foundation bring its holdings down below the amount specified by the statute.

It would appear that amounts accumulated in the year of death and in later years to redeem stock to pay death taxes, or to redeem stock which a foundation must dispose of, should not be considered unreasonable accumulations. To consider them so defeats the purpose of these two redemption provisions of the statute.

Finance Committee decision.—The committee amendments provide (sec. 537 of the code) that the reasonable needs of the business are to include the amount needed (or reasonably anticipated to be needed) in the year of death and in later years to make a section 303 redemption. The provision gives protection from the special tax on accumulated earnings (sec. 531) with respect to amounts redeemed to pay death taxes. The committee amendments also provide that reasonable needs

of the business include the amounts needed, or reasonably anticipated to be needed, to redeem from private foundations stock it held on October 9, 1969 (or received pursuant to a will or irrevocable trust treated as binding on October 9, 1969) which constituted excess business holdings. Both the amount of the accumulation and the time it is held must be reasonable under the circumstances.

The bill also provides that if funds are used to redeem stock to pay death taxes or to redeem excess holdings of private foundations, no inference is to be drawn from this, where amounts have been accumulated by the corporation in prior years, that such amounts represented unreasonable accumulations. Such a determination, if it is to be made, must be made without considering that the funds are used for these types of redemptions.

There is no comparable provision in the House bill.

This provision is effective with respect to the tax on accumulated earnings in taxable years ending after October 9, 1969. No inference is to be drawn from the enactment of this provision that such accumulations would not have been for the reasonable needs of the business in the absence of any such provision.

9. Special Contingency Reserves of Insurance Companies

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 subject to tax. The amounts deductible include not only additions to life insurance reserves but also interest paid on indebtedness and amounts in the nature of interest. Present law also specifies that these deductible amounts include interest on special contingency reserves established under the Federal Employees Group Life Insurance Act of 1954.

Problem.—The question which arises is whether deductions for interest paid on indebtedness and amounts in the nature of interest include interest paid on 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 the employee's working life the cost of providing him group term life and 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 premium payments by employers for the insurance coverage provided for employees. In some cases, the reserve is a combination of both types.

When this matter was considered in connection with the Life Insurance Company Income Tax Act of 1959, the Finance Committee Report, the floor manager's statement on the finance committee amendments, and the floor manager's explanation of the conference committee action all contained language based upon the assumption that special contingency reserves in general were covered by the deduction for interest paid on indebtedness, and amounts in the nature of interest, and that the specific reference to contingency reserves on Federal employees group life insurance was adopted merely to "make it clear" that a deduction was available to insurance companies for interest credited on this type of special contingency reserve. Moreover, these special contingency reserves are of the same nature as other reserves held for policyholders, the interest on and additions to which are deductible in arriving at the amount of income of the life insurance company subject to tax. There appears to be no reason for a difference in tax treatment for

these special contingency reserves. Despite the congressional intent, the Internal Revenue Service does not feel that it can so interpret present law.

Finance Committee decision.—The committee amendments provide specifically that in computing the taxable income of a life insurance company a deduction is to be allowed for interest paid on special contingency reserves under contracts of group term life insurance or group health and accident insurance which are established and maintained for the provision for insurance on retired lives, for premium stabilization, or for a combination of the two. A similar amendment is also made to the life insurance company provisions relating to the items taken into account as reserves for purposes of the so-called "Phase II" tax imposed on life insurance company income (i.e., the tax on gains from operations other than investment income).

There is no comparable provision in the House bill.

This provision, on the basis that it is declaratory of congressional intent, is made effective 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 of Life Insurance Companies.

Present law.—Life insurance companies presently are taxable on their investment income plus 50 percent of their remaining gains from operations. The remaining portion of a company's gain from operations is taxed to the company only when, and if, this amount is distributed to shareholders. The portion of an insurance company's income which is taxed currently is, for accounting purposes, placed in a "shareholders surplus account" which is the first amount considered as distributed to shareholders.

The portion of the insurance company's gain from operations not taxed currently is placed in an account called a "policyholders surplus account." Distributions from this account are considered as made only after any balance in the shareholders surplus account is exhausted. Distributions out of the policyholders account give rise to the so-called Phase III tax on life insurance companies; that is, the deferred tax becomes due when the amount is distributed to the shareholder. Included in distributions which may give rise to this tax are distributions in redemption of stock, distributions in partial liquidation and distributions 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.

Problem.—In the past, three exceptions have been made to the rule that there would be phase III tax consequences in the cases of a spinoff to shareholders of the stock of a subsidiary of the life insurance company: The spinoff of stock of a controlled fire and casualty insurance subsidiary company, if acquired before January 1, 1963, in a tax-free stock-for-stock reorganization; the spinoff of stock of a controlled fire and casualty insurance company subsidiary, without regard to the type of corporate reorganization in which the parent gained control of the subsidiary company, where the parent owned 80 percent or more of the stock of the subsidiary before January 1, 1958 (the effective date of the Insurance Company Act of 1959); and the spinoff of the stock of a subsidiary corporation which is also a life insurance company, if the spinoff is to a holding company which owns at least 80 percent

of the stock of the "first tier" life insurance company subsidiary which, in turn, owns (and has owned since December 31, 1957) at least 80 percent of the stock of the "second tier" life insurance company. The absence of the phase III tax, however, only applies to the extent there were no contributions to the capital of the second tier company after December 31, 1957 (the effective date of the Life Insurance Company Act of 1959).

Another case has come to the attention of the committee which differs from the third situation described above only in that the second tier subsidiary is an ordinary corporation subject to the general corporate tax provisions rather than a life insurance company. In this situation the life insurance company wants to spin off the stock of the ordinary business subsidiary to the parent holding company in order to simplify the operations of the group of corporations along functional lines. Moreover, certain States are considering legislation directed against continuing ownership by life insurance companies of noninsurance business interests.

The problem which exists here is that the removal of any assets from the possible application of the phase III tax (as would happen if the regular corporation could be spun off without any tax consequences) does lessen the certainty of the ultimate payment of the phase III tax by the life insurance company. This is particularly important where it is other than a life 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 generally be sold or distributed to shareholders without the application of a phase III tax.

Finance Committee decision.—The committee amendments 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 in a manner 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 as if distributions to the holding company by the ordinary business corporation were channelled through the life insurance company. The sale or other disposition of the stock of the ordinary business subsidiary by the 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 amendment applies only where a life insurance company has, at all times since December 31, 1957, owned all of the stock of the business subsidiary which is spun off to the parent holding company. In such cases the phase III tax is not to apply (except to the extent of any post-1957 contributions to capital of the business subsidiary) at the time of the spinoff but, as is indicated above, the phase III tax consequences will continue to apply to distributions by (or the sale of stock of) the ordinary business subsidiary.

There is no comparable provision in the House bill.

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

Present Law.—Under present law, the rules governing the income tax treatment of insurance companies differ somewhat, depending upon whether the company is a stock or mutual company and also depending upon the nature of the insurance company's 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.

Problem.—The limitation on the use of losses by insurance companies has been provided in the past primarily because 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 casualty companies were not taxed on their underwriting income and their losses were not taken into account for Federal tax purposes.) There appears to be no reason for this, however, if a company in changing its form of organization or the nature of its insurance business does not receive more favorable operating loss carryforwards than it would receive in the case of either type of organization.

Finance Committee decision.—The committee amendments permit 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. However, this provision forestalls any tax advantage in such a case by limiting the net operating loss which may be carried over 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 apply to the company after the change.

There is no comparable House provision.

This provision applies to the carryforward of losses incurred by insurance companies in periods beginning on or after January 1, 1963, but does not permit a deduction to be taken for any taxable year beginning before January 1, 1967.

12. Unit Investment Trusts

Present law.—A mutual fund plan sponsor is an underwriter who sponsors a periodic payment plan for the accumulation of mutual fund shares by small investors. Under present law, the Internal Revenue Service treats a group of periodic payment investors subscribing to a plan as "an association taxable as a corporation" because the bank serving as custodian is regarded as having power to invest their funds, thus giving the arrangement the corporate characteristics of centralized management.

Problem.—In fact, the bank custodian does not exercise managerial discretion but performs only ministerial functions in much the same manner as a brokerage office holding securities in its own name for a particular customer. As a result of treating the plan as a corporation, if an investor asks for his stock to be delivered to him, gain or loss is recognized on this transaction although the investor has merely taken down his own shares.

Finance Committee decision.—The committee amendments add a provision to the regulated investment company provisions providing that certain periodic payment plans are not to be treated as a corporation, partnership or trust and the mutual fund shares are to be treated as owned directly by the investors through the bank custodian as a nominee. The committee amendments apply to unit investment trusts registered under the Investment Act of 1940 which issues periodic payment plan certificates and meet certain other conditions.

The new provision does not apply in the case of a unit investment trust which is a separate asset account under the insurance laws or regulations of a State. For purposes of the security laws these separate asset accounts may in some cases be classified as either a unit investment trust type of investment company. In addition, the provision added by the committee amendments will not apply to other unit investment trusts sponsored by life insurance companies which are treated as a part of the assets of the sponsoring life insurance company for purposes of State insurance laws and for which a separate asset account also must be maintained. Under present law, trusts of this latter type may in some cases for Federal tax purposes be treated as part of the insurance company and in other cases as associations taxable separate from the life insurance company. In the latter case, such trusts may elect to be taxed as regulated investment companies. These unit investment trusts will continue to be taxed as associations.

There is no comparable House provision.

This provision is effective with respect to taxable years of unit investment trusts ending after December 31, 1968, and to taxable years of holders of interest in these trusts ending with or within the taxable years of these trusts.

13. Exclusion for Income Earned Abroad

Present law.—Present law provides an exclusion from income for purposes of U.S. tax for income earned from sources without the United States in the case of either a U.S. citizen who is a bona fide resident of a foreign country or a U.S. citizen who is present in a foreign country for at least 17 out of 18 consecutive months. The exclusion under present law is $25,000 a year in the case of a bona fide resident of a foreign country who has been such for a period of at least 3 years. In all other cases the exclusion under present law is $20,000.

Problem.—The problem which arises is that it is difficult to see why the U.S. citizen living abroad should have an appreciably lower tax rate than citizens living in the United States. While there are some services which may not be provided to the same extent for U.S. citizens living abroad as for those living at home, there are other services which in many cases are used more by citizens living abroad. Moreover, the citizen living abroad is likely to come back to the United States upon retirement and at that time receive many of the services provided domestically at a time 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. However, to the extent this is true the foreign tax credit prevents the doubling up of tax on such income. Moreover, there are cases where the foreign country, although it taxes such income when received in the foreign country, does not tax it where arrangements are

made for the citizen to have the funds deposited for him in the United States.

Finance Committee decision.—The Finance Committee amendments reduce from $20,000 or $25,000 (in this latter case where the individual is a bona fide resident of the foreign country for more than 3 years) to $6,000 the amount of earned income received from abroad which a U.S. citizen who is a bona fide resident of a foreign country or who is abroad for 17 out of 18 months may exclude from income in computing his U.S. income tax. There is no comparable provision in the House bill.

This amendment applies to taxable years beginning after the date of enactment of this bill.

14. Foreign Base Company Income

Present law.—Under present law, U.S. shareholders of controlled foreign corporations 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 one foreign country by one corporation and sold by a related corporation in another foreign country for use outside that country) and foreign base company services income. Basically, this provision is designed to prevent the avoidance of tax by arranging sales between related parties so that sales take place in a country which imposes little or no tax on this type of income where the production or other effort in connection with the property and the use of the property does not occur in that country. Present law provides an exception from this provision where it is established to the satisfaction of the Treasury Department 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.

Problem.—Cases have come to the attention of the committee where controlled foreign corporations have substantial investments in foreign countries which in practical terms they must dispose of because of the operation 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 created to reduce taxes and the purpose of the sale is to comply with foreign laws and not to reduce taxes.

Finance Committee decision.—The Finance Committee amendments deal with the type of problem described above by amending existing law (sec. 954(b)(4)) to provide that the exception from the tax imposed with respect to foreign base company income is to apply, if the Treasury Department is satisfied that neither the creation nor organization (or acquisition) of the controlled foreign corporation in the particular foreign country nor the transaction giving rise to the income in question has as one of its significant purposes a substantial reduction of income or similar taxes.

This amendment applies to taxable years ending after October 9, 1969.

15. Deferral of Gain Upon the Sale of Certain Low- and Middle-Income Housing

Present law.—Under present law, where an individual sells his personal residence to the extent he 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. Instead, the basis of the second residence is considered to be that of the first residence (plus any additional funds added) 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 low- and moderate-income housing held as rental property.

Problem.—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 low- or middle-income occupant 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, 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. This should enable them to make purchases they otherwise could not make.

Finance Committee decision.—In order to obtain a more favorable price for Government-assisted housing units where they are sold to the occupant or a tax-exempt organization managing the property, the committee amendments provide that no gain is to be recognized to the initial investor where the properties are sold in this manner but only to the extent that the investor reinvests the proceeds from the sale in other similar Government-assisted housing. In this case, the taxpayer's basis for the project is carried over and becomes part or all of his basis for the new project in which the funds are invested (depending upon whether or not he also invests additional funds in the second project). The holding period of the first property is taken into account in determining how long the second property is held in this case, but only to the extent the proceeds of sale of the old project are reinvested in the new project.

There is no comparable provision in the House bill.

This provision is effective with respect to sales made after October 9, 1969.

16. Cooperative Per-Unit Retain Allocations Paid in Cash

Present law.—Under present law, patronage dividends paid in money, qualified allocations or other property may be paid to the patron within 8½ 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. 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 8½ months after the end of the year, with the cooperative receiving a deduction for such amounts 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.

Problem.—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. These payments cannot be made during the 8½ month period as cash patronage dividends because they cannot be paid with respect to net earnings. The net earnings of the pool cannot be determined until the pool is closed, which may occur much later. Moreover, the payments can be made as per unit retain allocations only if they are paid as a qualified per unit retain certificates. There seems to be no reason why a cooperative should be able to deduct per unit retain allocations paid as qualified certificates during the 8½ month period following the close of the taxable year, but not per unit retain allocations paid in money during the same period.

Finance Committee decision.—The Finance 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 such provision is contained in the House bill.

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

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, was 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.

Problem.—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.

Finance Committee decision.—The committee amendments provide an exemption from the manufacturer's excise tax on trucks in the case of articles designed to be mounted on automobile truck trailer or semi-trailer chassis which are designed to be used primarily to process or prepare concrete. In addition, an exemption is provided for parts and accessories designed primarily to be used in connection with the use of these concrete mixers.

No comparable provision appears in the House bill.

This amendment applies to articles sold after June 30, 1969.

2. Constructive Sales Price

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 to a wholly owned sales subsidiary and the subsidiary resells to one or more independent wholesale distributors (Rev. Rul. 62–68). 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.

Problem.—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.

Finance Committee decision.—The Finance Committee's amendment adds 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 essentially the private ruling practice of the Internal Revenue Service. 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 arms 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, resells to independent wholesale distributors (or, perhaps, 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 to 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.

These amendments apply to articles sold after January 1, 1969.

BB. MISCELLANEOUS ADMINISTRATIVE PROVISIONS

1. Filing Requirement for Individuals

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.

Problem.—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 for the Internal Revenue Service.

Finance Committee decision.—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 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 levels are applicable only if they are living together at the end of the year. The filing requirement would remain at $600 for a married couple filing separate returns and those living apart. The House bill contained no comparable provision.

These changes apply to taxable years beginning after December 31, 1969.

2. Computation of Tax by Internal Revenue Service

Present law.—Presently taxpayers may request the Internal Revenue Service to compute their tax if their gross income is less than $5,000, they take the standard deduction, use the optional tax table and do not have nonwage income in excess of $100. The tax in this case does not take into account whether the taxpayer is a head-of-household or surviving spouse and does not take into account the retirement income credit.

Problem.—The present limitations on the type of taxpayer who may elect to have his tax computed by the Internal Revenue Service appear to be unduly restrictive.

Finance Committee decision.—The committee's amendments raise from $5,000 to $7,500 the income level up to which Internal Revenue Service will compute income tax (this amount may subsequently be raised to $10,000 if the Internal Revenue Service finds this practical). In addition, the Internal Revenue Service is to be permitted to issue regulations (without regard to the amount or the source of adjusted gross income, marital status, whether the taxpayer itemizes or takes a standard deduction, or the type of tax credits he claims) outlining the conditions under which the taxpayer may request the Internal Revenue Service to compute his tax.

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

3. Penalties for Failure to Pay Tax and Make Deposits

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, 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.

Problem.—Since the current cost of borrowing money is substantially in excess of the 6 percent interest rate provided by the Internal Revenue 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. Although full information is not available, borrowings of this type may be occurring on a substantial scale.

Finance Committee decision.—The committee amendments provide a penalty for failure to pay income tax when due. 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, while the failure continues, not exceeding 25 percent in all. The penalty in this case is imposed on the net amount due after taking into account amounts which have been withheld, estimated payments and other applicable credits. This penalty is not to be imposed if it is shown that the failure to pay the tax is due to reasonable cause and not to willful neglect.

The penalty applies to the tax due at the time of the filing of a return and also, in the case of a late-filed return only, to the amount of any deficiency subsequently determined to be payable. In addition, the 5 percent per month penalty applies to failures of withholding agents to pay over withholding tax when due.

There is no comparable House provision.

This provision applies to amounts payable on and after January 1, 1970.

4. Reporting of Medical Payments

Present time.—Present law provides that every person making payment 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 year must file an information return showing the amounts paid and the name and address and identification number of the recipient.

At the time the committee ordered this bill reported, the Internal Revenue Service did not require reporting of payments to doctors and other suppliers of health care services when payments were made to them by insurance companies and other organizations (including the Federal Government through the Medicare program and the Federal and State Governments through the Medicaid program and the Maternal and Child Health program). Since this bill has been ordered reported, however, the Service has ruled that insurance and other companies paying $600 or more a year to a doctor or other person rendering service under health plans must file annual information returns. The reporting requirement applies to payments made during 1969, but organizations not equipped to immediately provide the data may start filing returns as of January 1, 1970. The reporting requirement does not apply to cases where a patient submits a claim to the insurance company for a bill he has paid and is reimbursed by the insurance organization.

Problem.—It appears appropriate to require information returns with respect to payments in excess of $600 to suppliers of medical goods and services whether the payments are made to the supplier, to the patient or to others in reimbursement for payments or amounts payable to the supplier. The recent Internal Revenue Service requirement that information returns be provided with respect to payments to doctors does not fill the need for obtaining information where payments are made to patients for doctor bills. To omit this type of payment could well encourage doctors, dentists, etc., to seek the indirect, rather than

the direct, type of reimbursement in order to avoid having their payments reported to the Federal tax collector.

Finance Committee decision.—The committee amendments require the filing of information returns for payments of $600 or more to a supplier of medical goods and services, including doctors and dentists.

The information return requirement also applies to payments to doctors, dentists, etc., which are reimbursed by the insurance company or other organizations to the patient. All payments made to the doctors, dentists, etc., whether directly or through reimbursement, are to be aggregated in determining the amounts paid during a year.

The following exceptions are provided:

(1) The reporting requirements apply only in the case of payments made in the course of a trade or business and, therefore, do not, for example, apply to payments by the patient who pays a doctor bill.

(2) The reporting requirements do not apply to payments of wages subject to withholding, to payments to a tax-exempt organization, or to payments to a governmental unit or agency.

(3) The reporting requirements do not apply to goods and services supplied by noninstitutional pharmacists.

(4) The reporting requirements do not apply to payments to an individual by his attorney or agent.

(5) In the case of a settlement of a claim which includes reimbursements for amounts paid to a doctor, dentist, etc., reporting is required only to the extent these payments are separately identified by the person making the payment.

The amounts reported as payments to suppliers which are actually payments to other persons in reimbursement of the amounts billed by doctors, dentists, etc., will not always accurately reflect the actual income of the doctor, dentist, etc. Nevertheless, the amounts reported will be helpful to the Internal Revenue Service in selecting returns for audit, but the reports will not be used as evidence (in themselves) of income received by the doctor, dentist, etc.

The Secretary of Health, Education, and Welfare is also required to provide similar reporting to that outlined above with respect to Medicare and Medicaid. Moreover, he is also 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 childrens' services and the aggregate amounts paid to individuals under each program. The doctors, dentists, etc. are to be identified by the identifying number required to be included in the information return.

In addition, the Secretary of HEW is to submit to the Senate Finance Committee and the House Ways and Means Committee an annual report identifying each person paid $25,000 or more during the preceding year under Medicare and Medicaid programs or programs for maternal, child health and crippled childrens' services.

No comparable provision is contained in the House bill.

The provisions requiring reporting with respect to Medicare, Medicaid and other Federal program payments either by the Secretary of

HEW or by private carriers or other organizations are to be effective for calendar years beginning after 1968. 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

Present law.—The Tax Court is at present an independent agency in the executive branch, where taxpayers may take income, estate, and gift tax cases for redetermination of deficiencies (including a determination that there not only is no deficiency but that there is an overpayment) before paying the taxes. The 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 does not have the power to punish for contempt, even in the case of violations of subpoenas 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.

Judges must retire upon reaching age 70 if they have completed 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 receive a Civil Service pension even though rights to the pension may have accrued before he became a judge. Also he may not receive back his Civil Service contributions if he elects the Tax Court pension.

Problem.—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.

Often taxpayers with small claims believe that there is no inexpensive practical way for them to present their claims before an impartial tribunal and, therefore, 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 may 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 of the proceedings must be prepared of the proceedings in each case and the findings of fact and the 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.

Since the Tax Court has only judicial duties it appears anomalous to classify it with quasi-judicial executive agencies that have rule making and investigatory functions. 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 2 or 3 years or possibly only several months. It would appear appropriate that Tax Court judges have longer, more uniform terms.

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 not permitted to collect Civil Service retirement pensions if they elect Tax Court retirement, nor are they permitted to receive back their contributions to the Civil Service retirement fund. District Court judges, however, are permitted to collect Civil Service retirement pensions in addition to their pensions as judges. Also, District Court pensions are more favorable as a proportion of salary than those available to Tax Court judges. Finally, the present provisions severely restrict the occasions when a Tax Court judge may apply for survivor benefits.

Finance Committee decision.—The committee amendments provide for a small claims procedure, where neither the disputed amount of the deficiency nor the claimed overpayment exceeds $1,000 as to any year, or where the amount in an estate tax matter does not exceed $1,000, a simplified and relatively informal procedure is to be available to the taxpayer.

In such a case the decision is to be based upon a brief summary opinion instead of formal findings of fact; the decision is not to be a precedent for future cases and is not to be reviewable upon appeal. In addition, the Court is to be given discretion as to rules of evidence and procedure with the expectation that the Court would follow relatively informal rules whenever possible. The use of the small claims procedure would be optional with the taxpayer except that the Tax Court (presumably upon the request of the Internal Revenue Service) can decide before the hearing that the case involves an important tax policy which should be heard under normal procedures and should be subject to appeal. Where it becomes evident to the Court during, or at the end of, the trial of a case that the deficiency or overpayment should be increased to an amount in excess of $1,000, then the Court has the discretion to shift the case to the regular procedures for 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. Commissioners can be used by the Tax Court in these cases as well as in regular cases and are to be paid at the same rate as commissioners of the Court of Claims.

The committee amendments also establish the Tax Court as a court under Article I of the Constitution, dealing with the legislative branch. 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. The Tax Court is given the same powers regarding contempt that Congress has previously given to the District Courts.

The method of appointment of the 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 takes office. A judge may not be appointed for the first time after reaching age 65.

The provisions regarding retirement are revised to require retirement at age 70 whether or not the judge has completed 10 years of service at that time. (The bill, however, does not change the provision of existing law authorizing the recall of retired judges to relieve heavy case loads.) As in the case of the District Court, the bill also permits a judge to retire at age 65 if he has served 15 years. He may retire at a younger age with 15 years of service if he is available for reappointment at the conclusion of his term but is not reappointed. The bill also requires a Tax Court judge to retire if he is permanently disabled. Generally, retirement under these provisions is to be at the full pay of the office except that if a judge has served less than 10 years then his pension is apportioned in accordance with the number of years served (if he retires for disability and has served less than 10 years his pension is half the salary of the office).

The bill retains the provision to the effect 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.

In addition, minor amendments are made to conform the statute to the terminology and time period (90 days instead of 3 months) applicable to appeals from trial courts under the Federal Rules of Appellate Procedure.

There are no comparable provisions in the House bill.

The provision dealing with the treatment of small tax cases is to be effective 1 year after the bill's enactment. The other provisions are generally effective on date of enactment except that in the case of judges who are now members of the Court transition rules are provided with respect to their status for retirement purposes.

DD. HOUSE PROVISIONS DELETED BY COMMITTEE

1. Limitation on Deduction of Interest

Present law.—Present law allows individual taxpayers an itemized deduction, without limitation, for all interest paid or accrued during the taxable year.

Problem.—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.

Finance Committee decision.—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 Finance Committee amendments delete this provision. However, interest expense in excess of investment income is an item included in the base for the minimum tax.

2. Other Deferred Compensation

Present law.—In 1960, the Internal Revenue Service issued a comprehensive ruling (Revenue Ruling 60–31) describing various types of 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 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.

Problem.—The present treatment of deferred compensation under the Internal Revenue Service ruling 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.

Finance Committee decision.—The House provision 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 rates which would have been applicable had the income been received when earned. This result would be 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 bases the tax on the average compensation for the three highest years during the last 10 years of the earning period.

The committee amendments delete this provision. The Treasury Department informed the committee that this provision is too complicated and requires further study. A group has been established by the Treasury Department to carry on this work.

3. Foreign Tax Credit

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.

Problem.—Since the per country limitation is computed separately for each foreign country, losses which occur in one country reduce U.S. tax on domestic income, rather than reducing the credit for taxes paid to other foreign countries (as would occur under the overall limitation). However, when the business operation in the loss country becomes profitable, the income, in effect, is likely not to be taxed by the United States because the foreign country is likely to impose a tax equal to the U.S. tax and, as a result, a foreign tax credit is likely to be allowed with respect to that income.

Another problem which may arise (primarily where the overall limitation is used) is the difficulty of distinguishing royalty payments from tax payments. This problem is likely to arise in cases where the taxing authority in a foreign country is also the owner of mineral rights in that country. Since royalty payments may not be credited against U.S. taxes, the allowance of a foreign tax credit for a payment which, although called a tax, is, in fact, a royalty, allows a taxpayer a larger reduction in U.S. tax than would occur than if a deduction (instead of the credit) were available. Where the credit exceeds the U.S. tax on the income from the mineral production in the foreign country, the excess credit may be used to offset U.S. tax on income from other operations in that country, or on income from other foreign countries.

Finance Committee decision.—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 Finance Committee has deleted these two provisions of the House bill and requested that they be given further study.

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4. Cooperatives: Payment of Patronage Allocations

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 not taken into account by 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.

Problem.—Generally, qualified patronage allocations and qualified per-unit retains are considered as amounts distributed by cooperatives to their patrons and reinvested in the cooperatives as capital. However, some attach significance to the fact that a patron on an individual basis normally does not have an independent choice between reinvesting the funds in the cooperative or retaining them for his own use. This choice is generally made by the members of the cooperative as a group. Despite this, it is pointed out that in most cases the patron is taxed as though he had full dominion and control over the patronage allocation or per-unit retain. The concern in this regard is that while most cooperatives revolve out these funds—on which the patron has already paid the tax—within 4 to 15 years, some cooperatives may retain the funds indefinitely.

Since the funds are taxed to the patron at the present time and since this change would not require any tax payment at the cooperative level but only the ultimate distribution of the funds to the patron over a shorter period than has sometimes been the case, the committee does not believe that the House provisions represent a revenue problem. The committee has asked the staff, however, to study problems as to the tax treatment of cooperatives, particularly as to whether cooperatives engage in activities which are unrelated to the purposes for which special tax treatment is given, and it has asked that a report be made back to it on this subject.

Finance Committee decision.—The House bill would have required cooperatives to revolve out patronage dividends and per unit retains within 15 years from the time the written notice of allocation was made or the per-unit retain certificate was issued. In addition, the percentage of patronage allocations which would have had to be paid out currently in cash or by qualified check was increased from 20 percent to 50 percent. The additional 30 percent would have had to have been paid with respect to the current allocations or in redemption of prior allocations. The increase in the required payout would have been phased in ratably over a 10-year period. These provisions were to apply to taxable years beginning after 1969.

The Finance Committee amendments delete these provisions.

5. Maximum Tax on Earned Income

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.

Finance Committee decision.—The House bill 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 to reach 65 percent in 1972 and later years). The committee amendments delete this provision.

EE. REVENUE ESTIMATES AND BURDEN TABLES

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

[In millions of dollars]

A. AS APPROVED BY THE SENATE COMMITTEE ON FINANCE

	1970	1971	1972	1974	1979
Tax reform program under Finance Committee bill	+1,400	+1,655	+1,880	+2,440	+3,335
Repeal of investment credit	+2,500	+2,990	+2,990	+3,090	+3,270
Tax reform and repeal of investment credit	+3,900	+4,645	+4,870	+5,530	+6,605
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	−2,363

B. AS PASSED BY THE HOUSE OF REPRESENTATIVES

	1970	1971	1972	1974	1979
Tax reform program under House bill [1]	+1,665	+2,080	+2,215	+2,650	+3,570
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	+6,870
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	−2,403

[1] Revised.

Note: The tax surcharge extension ($3,100,000,000 liability for 1970) and the excise tax extension ($1,170,000,000, $800,000,000, $800,000,000, and $400,000,000 for 1970 through 1973, respectively) are not included because of their impermanent character.

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

[In millions of dollars]

A. AS APPROVED BY THE SENATE COMMITTEE ON FINANCE

	1970	1971	1972	1974	1979
Tax reform program under Finance Committee bill	+1,400	+1,655	+1,880	+2,440	+3,335
Repeal of investment credit	+2,500	+2,990	+2,990	+3,090	+3,270
Tax reform and repeal of investment credit	+3,900	+4,645	+4,870	+5,530	+6,605
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	−2,363

B. AS PASSED BY THE HOUSE OF REPRESENTATIVES

	1970	1971	1972	1974	1979
Tax reform program under House bill [2]	+1,665	+2,080	+2,215	+2,650	+3,570
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	+6,870
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	−2,403

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

Note: The tax surcharge extension ($3,100,000,000 liability for 1970) and the excise tax extension ($1,170,000,000, $800,000,000, $800,000,000 and $400,000,000, for 1970 through 1973, respectively) are not included above because of their impermanent character.

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

A. AS APPROVED BY THE SENATE COMMITTEE ON FINANCE

Adjusted gross income class	Tax under present law [1] (millions)	Increase (+) decrease (−) from reform and relief provisions	
		Amount (millions)	Percentage
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 OF REPRESENTATIVES

Adjusted gross income class	Tax under present law [1] (millions)	Increase (+) decrease (−) from reform and relief provisions	
		Amount (millions)	Percentage
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.—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						Total, all provisions
		Low income allowance	Elimination of phaseout	15 percent, $2,000 standard deduction	General rate reduction	Tax treatment of single persons	Total relief 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							Total, all 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	
	millions								
0 to $3,000	+$16	-$552	-$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

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

[*millions*]

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
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	[3] +55	+10	−110	+20	+30	+130	−110	+25	+25	+255	+80	+320	+1,125

B. AS PASSED BY THE HOUSE OF REPRESENTATIVES

[*millions*]

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	Limited tax preference	Allocation	Total
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	[3] +70	+10	−300	+25	+20	+20	+70	+70	−100	[3] +25	+260	+80	+85	[3] +470	+1,380

[1] Assumes ½ of effect as compared with no change in realization. [2] Less than $500,000. [3] These full year effect estimates exceed the estimates for 1979 in Table 6.

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	1979	1970	1971	1972	1974	1979
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	[3] 20
Moving expenses	−110	−110	−110	−110	−110	−100	−100	−100	−100	−100
Railroad amortization	−125	−115	−160	−185	−105	(2)	−5	−[4] 15	−[4] 60	−[4] 85
Amortization of pollution facilities[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 bank:										
Reserve	225	150	125	100	100	250	250	250	250	250
Capital gain	(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	[3] 40	(2)	5	10	25	[3] 50
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 [5]	60	140	185	260	310	60	140	185	260	310
Cooperatives						(2)	(2)	(2)	(2)	(2)
Limit on tax preference						40	50	60	70	85
Allocation						205	420	425	440	[3] 460
Tax on preference income	650	655	665	690	700					
Real estate:										
Used property [5]	15	40	65	150	250	15	40	65	150	250
New nonhousing [6]	(2)	60	170	435	960	(2)	60	170	435	960
Capital gain, recapture	(2)	10	20	40	100	5	15	25	50	125
Rehabilitation [5]	−15	−50	−100	−200	−330	−15	−50	−100	−200	−330
Total tax reform	1,400	1,655	1,880	2,440	3,335	[4] 1,665	[4] 2,080	[4] 2,215	[4] 2,650	[4] 3,570
Plus investment credit	2,500	2,990	2,990	3,090	3,270	2,500	3,000	3,000	3,100	3,300
Total	3,900	4,645	4,870	5,530	6,605	[4] 4,165	[4] 5,080	[4] 5,215	[4] 5,750	[4] 6,870

[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] Full year effect: farm losses $25,000,000; pension plans, $55,000,000 under Senate Finance Committee and $70,000,000 under House bill; and allocation, $470,000,000. See Table 5.
[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	4,904
$3,000 to $5,000	9,562	405	9,157
$5,000 to $7,000	9,779	24	9,755
$7,000 to $10,000	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 $100,000	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	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	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	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	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	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

Provision	Fiscal year 1970	Fiscal year 1971
Tax reform provisions (+):		
Corporation [1]	+$0.3	+$0.8
Individual [2]	+([3])	+.5
Total, tax reform provisions	+.3	+1.3
Tax relief provisions (−):		
Individual	[4]−.7	−3.0
Other provisions (+):		
Repeal of investment credit:		
Corporation	+.9	+1.9
Individual	+.4	+.6
Total, repeal of investment credit	+1.3	+2.5
Extension of tax surcharge:		
Corporation	+.3	+.7
Individual	+1.7	+.4
Total, surcharge extension	+2.0	+1.1
Extension of excise taxes	+.5	+1.1
Total, other provisions	+3.8	+4.7
Total, all provisions	+3.4	+3.0

As passed by the House of Representatives

Provision	Fiscal year 1970	Fiscal year 1971
Tax reform provisions (+):		
Corporation	+$0.4	+$1.0
Individual	+.3	+.6
Total, tax reform provisions	+.7	+1.6
Tax relief provisions (−):		
Individual	−.7	−3.6
Other provisions (+):		
Repeal of investment credit:		
Corporation	+.9	+1.9
Individual	+.4	+.6
Total, repeal of investment credit	+1.3	+2.5
Extension of tax surcharge:		
Corporation	+.3	+.7
Individual	+1.7	+.4
Total, surcharge extension	+2.0	+1.1
Extension of excise taxes	+.5	+1.1
Total, other provisions	+3.8	+4.7
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.

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