TECHNICAL CORRECTIONS ACT OF 1979

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SIXTH CONGRESS

FIRST SESSION

ON

S. 873

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO WAIVE IN CERTAIN CASES THE RESIDENCY REQUIREMENTS FOR DEDUCTIONS OR EXCLUSIONS OF INDIVIDUALS LIVING ABROAD

S. 1549

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO CHANGE THE PERIOD FOR THE PAYMENT OF TAXES UNDER SECTION 4161(a) OF SUCH CODE

H.R. 2797

AN ACT TO MAKE TECHNICAL CORRECTIONS RELATED TO THE REVENUE ACT OF 1978

NOVEMBER 7, 1979

Printed for the use of the Committee on Finance

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TECHNICAL CORRECTIONS ACT OF 1979

WEDNESDAY, NOVEMBER 7, 1979

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee convened at 2:40 p.m., pursuant to call, in room 2221, Dirksen Senate Office Building, Senator Harry F. Byrd, Jr., presiding.

Present: Senators Byrd and Boren.

[The press releases announcing this hearing and the bills H.R. 2797, S. 873 and S. 1549 and Joint Committee on Taxation description of S. 873 and S. 1549 and description of H.R. 2797 follow:]

[Press Release No. H-66, Oct. 16, 1979]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARING ON TECHNICAL CORRECTIONS ACT OF 1979

Senator Harry F. Byrd, Jr. (I., Va.), Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance announced today that the Subcommittee will hold a hearing on Wednesday, November 7, 1979 on the Technical Corrections Act of 1979.

The hearing will begin at 2:30 p.m. in Room 2221 of the Dirksen Senate Office Building.

The bill, which the House of Representatives passed on July 18, 1979, contains technical, clerical, conforming, and clarifying amendments to provisions enacted by the Revenue Act of 1978 and other 1978 tax legislation.

Senator Byrd said, "In any major tax legislation, especially legislation enacted under great time pressure, minor errors and omissions escape detection. Such errors may not involve major questions of tax policy. However, they do make it more difficult for both taxpayers and the Internal Revenue Service in dealing with the tax law. Accordingly, enactment of corrective legislation should be of substantial assistance to the tax community, both in and out of government.

"Prior to the creation of the present subcommittee structure it was difficult to find time in the legislative process to consider technical material such as the items contained in this bill. One of the important functions of the Subcommittee on Taxation and Debt Management, however, is to perform the difficult detail work which is required if the Internal Revenue Code is to remain a properly-functioning law."

Testimony is invited both on the bill as passed by the House of Representatives and on any propoed additions to or deletions from that bill. It is recommended, however, that witnesses who only wish to support provisions now contained in the House bill limit their testimony to the submission of written statements.

It is also recommended that written and oral statements deal both with the merits of the issue involved and with the question of whether it is or is not a technical rather than a policy change.

Witnesses who desire to make oral statements at the hearing should submit a written request to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, by no later than the close of business on November 1, 1979.

Legislative Reorganization Act.—Senator Byrd stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before Commit-

tees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to speak should comply with the following rules:

(1) A copy of the statement must be filed by noon the day before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Witnesses are not to read their written statements to the Subcommittee, but are to confine their oral presentations to a summary of the points included in the statement.

Written testimony.—Written testimony submitted by witnesses not making oral statements should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies by November 14, 1979, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510.

[Press Release No. H-72, Nov. 2, 1979]

Finance Subcommittee on Taxation and Debt Management Amends Hearing Notice

Senator Harry F. Byrd, Jr., (I., Va.), Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, announced today that the subject matter of the hearing on Wednesday, November 7, 1979 will include S. 1549, dealing with the excise tax on fishing tackle, and S. 873, dealing with residency requirements for deductions and exclusions for individuals living and working abroad, as well as the Technical Corrections Act of 1979.

The hearing will begin at 2:30 p.m. in Room 2221 of the Dirksen Senate Office Building.

The subject matter of S. 1549 is included in H.R. 5505, which the House of Representatives passed on October 30, 1979. S. 1549 revises the schedule for payment of the 10-percent excise tax imposed upon the manufacturer's sale of fishing rods, reels, creels and artificial lures, baits and flies. The measure is sponsored by Senators Boren, Bellmon, Danforth, Durenberger, Nelson, and Percy. It has no revenue effect. It will benefit manufacturers of fishing equipment.

S. 873 is sponsored by Senators Ribicoff, Bentsen, Church, Hayakawa, Javits and Tower. It would waive the residency requirements for deduction or exclusions of individuals living and working abroad where the individual was forced to return to the United States by circumstances beyond his control in the country in which he is working. The bill would primarily benefit Americans working in Iran who recently were forced to leave. Revenue estimates on this measure are not available at this time.

Witnesses who desire to make oral statements at the hearing should submit a written request to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, by no later than 12:00 noon on November 6, 1979.

Legislative Reorganization Act.—Senator Byrd stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to speak should comply with the following rules:

(1) A copy of the statement must be filed by noon the day before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted by the close of business the day before the witness is scheduled to testify.

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Written testimony.—Written testimony submitted by witnesses not making oral statements should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies by November 14, 1979, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510.

96TH CONGRESS
1ST SESSION

S. 873

To amend the Internal Revenue Code of 1954 to waive in certain cases the residency requirements for deductions or exclusions of individuals living abroad.

IN THE SENATE OF THE UNITED STATES

APRIL 4 (legislative day, FEBRUARY 22), 1979

Mr. RIBICOFF (for himself, Mr. BENTSEN, and Mr. TOWER) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to waive in certain cases the residency requirements for deductions or exclusions of individuals living abroad.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) subsection (j) of section 913 of the Internal Revenue
4 Code of 1954 (relating to deduction for certain expenses of
5 living abroad) is amended by adding at the end thereof the
6 following new paragraph:

1 "(4) WAIVER OF PERIOD OF STAY IN FOREIGN
2 COUNTRY.—For purposes of paragraphs (1) and (2) of
3 subsection (a), an individual who for any period is a
4 bona fide resident of or is present in a foreign country
5 and who—
6 "(A) leaves such foreign country—
7 "(i) during any period during which the
8 Secretary determines, after consultation with
9 the Secretary of State or his delegate, that
10 individuals were required to leave such for-
11 eign country because of war, civil unrest, or
12 similar adverse conditions in such foreign
13 country which precluded the normal conduct
14 of business by such individuals, and
15 "(ii) before meeting the requirements of
16 such paragraphs (1) and (2), and
17 "(B) establishes to the satisfaction of the
18 Secretary that he could reasonably have been ex-
19 pected to have met such requirements,
20 shall be treated as having met such requirements with
21 respect to that period during which he was a bona fide
22 resident or was present in the foreign country.".
23 (b)(1) The amendments made by subsection (a) shall
24 apply to taxable years beginning after December 31, 1976,
25 but only with respect to periods an individual was a bona fide

1 resident of or present in a foreign country and did not meet
2 the requirements of section 913(a) (1) or (2) of the Internal
3 Revenue Code of 1954 with respect to such periods because
4 he left the foreign country after September 1, 1978.

5 (2) The Secretary of the Treasury or his delegate may
6 make determinations under section 913(j)(4)(A)(i) of such
7 Code, as added by subsection (a), for any period after Sep-
8 tember 1, 1978.

9 (3) In the case of an individual who elects under section
10 209(c) of the Foreign Earned Income Act of 1978 not to
11 have the amendments made by that Act apply, the Secretary,
12 for purposes of section 911 (a)(1) and (a)(2) of the Internal
13 Revenue Code of 1954, as in effect before such amendments,
14 shall apply rules for determining periods of residence or pres-
15 ence in a foreign country similar to the rules provided in
16 section 913(j)(4) of such Code, as added by subsection (a).

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II

96TH CONGRESS
1ST SESSION

S. 1549

To amend the Internal Revenue Code of 1954 to change the period for the payment of taxes under section 4161(a) of such Code.

IN THE SENATE OF THE UNITED STATES

JULY 20 (legislative day, JUNE 21), 1979

Mr. BOREN (for himself, Mr. BELLMON, Mr. NELSON, and Mr. PERCY) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to change the period for the payment of taxes under section 4161(a) of such Code.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 SECTION 1. Section 6302 of the Internal Revenue Code
4 of 1954 (relating to mode or time of collecting tax) is amend-
5 ed by adding at the end thereof the following new subsection:
6 "(d) TIME FOR PAYMENT OF MANUFACTURERS'
7 EXCISE TAX ON RODS, CREELS, ETC.—The tax imposed

1 by section 4161(a) (relating to manufacturers' excise tax on
2 rods, creels, etc.) shall be due and payable—
3 "(1) in the case of articles sold during the quarter
4 ending December 31, on March 31,
5 "(2) in the case of articles sold during the quarter
6 ending March 31, on June 30,
7 "(3) in the case of articles sold during the quarter
8 ending June 30, on September 24, and
9 "(4) in the case of articles sold during the quarter
10 ending September 30, at such time as the Secretary
11 may by regulations prescribe.".
12 SEC. 2. The amendment made by the first section of this
13 Act shall apply to articles sold on or after October 1, 1979.

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96TH CONGRESS
1ST SESSION

H.R. 2797

II

IN THE SENATE OF THE UNITED STATES

JULY 18 (legislative day, JUNE 21), 1979

Read twice and referred to the Committee on Finance

AN ACT

To make technical corrections related to the Revenue Act of 1978.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. SHORT TITLE, ETC.**
4 (a) SHORT TITLE.—This Act may be cited as the
5 "Technical Corrections Act of 1979".
6 (b) AMENDMENT OF 1954 CODE.—Except as otherwise
7 expressly provided, whenever in this Act an amendment or
8 repeal is expressed in terms of an amendment to, or repeal of,
9 a section or other provision, the reference shall be considered

1 to be made to a section or other provision of the Internal
2 Revenue Code of 1954.

3 SEC. 2. COORDINATION OF ENACTMENT DATES OF REVENUE
4 ACT OF 1978 AND ENERGY TAX ACT OF 1978.

5 The Revenue Act of 1978 is amended by inserting after
6 section 3 the following new section:

7 "SEC. 4. COORDINATION OF ENACTMENT DATES WITH
8 ENERGY TAX ACT OF 1978.

9 "For purposes of applying the amendments made by
10 this Act to sections 46 and 48 of the Internal Revenue Code
11 of 1954, the Energy Tax Act of 1978 shall be deemed to
12 have been enacted immediately before this Act."

13 TITLE I—AMENDMENTS RELATED 14 TO REVENUE ACT OF 1978

15 SEC. 101. AMENDMENTS RELATED TO TITLE I.

16 (a) GENERAL RULE.—

17 (1) AMENDMENT RELATED TO SECTION 104 OF
18 THE ACT.—Subparagraph (C) of section 43(c)(1) (relat-
19 ing to individual entitled to exclude income under sec-
20 tion 911 not eligible individual) is amended to read as
21 follows:

22 "(C) INDIVIDUAL WHO CLAIMS BENEFITS
23 OF SECTION 911, 913, OR 931 NOT ELIGIBLE IN-
24 DIVIDUAL.—The term 'eligible individual' does

1 not include an individual who, for the taxable
2 year, claims the benefits of—
3 "(i) section 911 (relating to income
4 earned by individuals in certain camps out-
5 side the United States),
6 "(ii) section 913 (relating to deduction
7 for certain expenses of living abroad), or
8 "(iii) section 931 (relating to income
9 from sources within possessions of the
10 United States)."
11 (2) AMENDMENTS RELATED TO SECTION 105 OF
12 THE ACT.—
13 (A) PAYMENTS TREATED AS EARNED
14 INCOME FOR AFDC.—Section 402 of the Social
15 Security Act is amended by adding at the end
16 thereof the following new subsection:
17 "(d) For purposes of paragraphs (7) and (8) of subsection
18 (a), any refund of Federal income taxes made by reason of
19 section 43 of the Internal Revenue Code of 1954 (relating to
20 earned income credit) and any payment made by an employer
21 under section 3507 of such Code (relating to advance pay-
22 ment of earned income credit) shall be considered earned
23 income."

1 (B) PAYMENT TREATED AS EARNED
2 INCOME FOR SSI.—Section 1612(a)(1) of the
3 Social Security Act is amended—
4 (i) by striking out "and" at the end of
5 subparagraph (A); and
6 (ii) by adding after subparagraph (B) the
7 following new subparagraph:
8 "(C) any refund of Federal income taxes
9 made by reason of section 43 of the Internal Rev-
10 enue Code of 1954 (relating to earned income
11 credit) and any payment made by an employer
12 under section 3507 of such Code (relating to ad-
13 vance payment of earned income credit); and".
14 (C) EFFECTIVE DATE FOR ADVANCE PAY-
15 MENT OF EARNED INCOME CREDIT.—Paragraph
16 (2) of section 105(g) of the Revenue Act of 1978
17 (relating to effective date for advance payment of
18 earned income credit) is amended by striking out
19 "June 30, 1978" and inserting in lieu thereof
20 "June 30, 1979".
21 (D) CLERICAL ADMENDMENT.—Subsection
22 (h) of section 43 (relating to coordination with ad-
23 vance payments of earned income credit) is redes-
24 ignated as subsection (g).

1 (3) AMENDMENT RELATED TO SECTION 112 OF
2 THE ACT.—Paragraph (8) of section 128(a) (relating to
3 cross references) is amended by striking out "benefits,
4 see" and inserting in lieu thereof "benefits which are
5 not includible in gross income under section 85,".
6 (4) AMENDMENT RELATED TO SECTION 131 OF
7 THE ACT.—Subparagraph (B) of section 457(d)(9) (re-
8 lating to application to rural electric cooperatives of
9 rules for eligible State deferred compensation plans) is
10 amended to read as follows:
11 "(B) RURAL ELECTRIC COOPERATIVE DE-
12 FINED.—For purposes of subparagraph (A), the
13 term 'rural electric cooperative' means—
14 "(i) any organization which is exempt
15 from tax under section 501(a) and which is
16 engaged primarily in providing electric serv-
17 ice on a mutual or cooperative basis, and
18 "(ii) any organization described in para-
19 graph (4) or (6) of section 501(c) which is
20 exempt from tax under section 501(a) and at
21 least 80 percent of the members of which are
22 organizations described in clause (i)."
23 (5) AMENDMENTS RELATED TO SECTION 134 OF
24 THE ACT.—

1 (A) EMPLOYMENT REQUIREMENT.—Subpar-
2 agraph (B) of section 125(g)(3) (relating to certain
3 participation eligibility rules not treated as dis-
4 criminatory) is amended by striking out "service
5 requirement" each place it appears and inserting
6 in lieu thereof "employment requirement".
7 (B) EFFECTIVE DATE.—Subsection (c) of
8 section 134 of the Revenue Act of 1978 is
9 amended by striking out "taxable years" and in-
10 serting in lieu thereof "plan years".
11 (6) AMENDMENTS RELATED TO SECTION 141 OF
12 THE ACT.—
13 (A) AMENDMENT TO ANTI-FLOW-THROUGH
14 RULES.—Paragraph (9) of section 46(f) (relating
15 to special rule for additional credit) is amended—
16 (i) by striking out "subparagraph (B) of
17 subsection (a)(2)" each place it appears and
18 inserting in lieu thereof "subparagraph (E) of
19 subsection (a)(2)", and
20 (ii) by striking out "an employee stock
21 ownership plan which meets the require-
22 ments of section 301(d) of the Tax Reduction
23 Act of 1975" in subparagraph (A) and in-
24 serting in lieu thereof "an ESOP which
25 meets the requirements of section 409A".

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1 (B) CLARIFICATION OF EFFECTIVE DATE.—
2 Section 141 of the Revenue Act of 1978 (relating
3 to ESOPS) is amended by striking out subsection
4 (g) and inserting in lieu thereof the following new
5 subsections:
6 "(g) EFFECTIVE DATES FOR ESOPS.—
7 "(1) IN GENERAL.—Except as otherwise provided
8 in this subsection and subsection (h), the amendments
9 made by this section shall apply with respect to quali-
10 fied investment for taxable years beginning after De-
11 cember 31, 1978.
12 "(2) ELECTION TO HAVE AMENDMENTS APPLY
13 DURING 1978.—At the election of the taxpayer, para-
14 graph (1) shall be applied by substituting 'December
15 31, 1977' for 'December 31, 1978'. An election under
16 the preceding sentence shall be made at such time and
17 in such manner as the Secretary of the Treasury or his
18 delegate shall prescribe. Such an election, once made,
19 shall be irrevocable.
20 "(3) VOTING RIGHT PROVISIONS.—Section
21 409A(e) of the Internal Revenue Code of 1954 (as
22 added by subsection (a)) shall apply to plans to which
23 section 409A of such Code applies, beginning with the
24 first day of such application.

1 "(4) RIGHT TO DEMAND EMPLOYER SECURITIES,
2 ETC.—Paragraphs (1)(A) and (2) of section 409A(h) of
3 the Internal Revenue Code of 1954 (as added by sub-
4 section (a)) shall apply to distributions after December
5 31, 1978, made by a plan to which section 409A of
6 such Code applies.

7 "(5) ELECTION TO HAVE NEW PUT OPTION RULE
8 APPLY.—The employer may elect to treat section
9 409A(h)(1)(B) of the Internal Revenue Code of 1954
10 (as added by subsection (a)) as applying to employer
11 securities in a plan to which section 409A of such
12 Code applies which are attributable to qualified invest-
13 ment for taxable years beginning before January 1,
14 1979. Such an election, once made, may be revoked
15 only with the consent of the Secretary of the Treasury
16 or his delegate.

17 "(6) SUBSECTION (f)(7).—The amendment made
18 by subsection (f)(7) shall apply to years beginning after
19 December 31, 1978.

20 "(7) RETROACTIVE APPLICATION OF AMEND-
21 MENT MADE BY SUBSECTION (d).—In determining the
22 regular tax deduction under section 56(c) of the Inter-
23 nal Revenue Code of 1954 for any taxable year begin-
24 ning before January 1, 1979, the amount of the credit
25 allowable under section 38 of such Code shall be deter-

1 mined without regard to section 46(a)(2)(B) of such
2 Code (as in effect before the enactment of the Energy
3 Tax Act of 1978).
4 "(h) EFFECTIVE DATES FOR LESOPS.—Paragraphs
5 (5) and (6) of subsection (f) shall apply—
6 "(1) insofar as they make the requirements of sub-
7 sections (e) and (h)(1)(B) of section 409A of the Inter-
8 nal Revenue Code of 1954 applicable to section 4975
9 of such Code, to stock acquired after December 31,
10 1979, and
11 "(2) insofar as they make paragraphs (1)(A) and
12 (2) of section 409A(h) of such Code applicable to such
13 section 4975, to distributions after December 31,
14 1979."
15 (C) DEFINITION OF QUALIFYING EMPLOYER
16 SECURITY FOR LEVERAGED EMPLOYEE STOCK
17 OWNERSHIP PLAN.—The first sentence of para-
18 graph (8) of section 4975(e) (defining qualifying
19 employer security) is amended to read as follows:
20 "The term 'qualifying employer security' means any
21 employer security within the meaning of section
22 409A(l)."
23 (D) NONRECOGNITION OF GAIN ON CONTRI-
24 BUTION TO ESOP.—Subsection (m) of section

1 409A (relating to contributions of stock of controlling corporation) is amended to read as follows:

3 "(m) NONRECOGNITION OF GAIN OR LOSS ON CONTRIBUTION OF EMPLOYER SECURITIES TO ESOP.—No gain or loss shall be recognized to the taxpayer with respect to the transfer of employer securities to an ESOP maintained by the taxpayer to the extent that such transfer is required under subparagraph (A) or (B) of section 48(n)(1)."

9 (E) LESOPS MAY DISTRIBUTE CASH IN CERTAIN CASES.—Paragraph (2) of section 409A(h) (relating to allowing plan to distribute cash in certain cases) is amended by inserting "or of section 4975(e)(7)" after "the requirements of this section".

15 (F) MATCHED EMPLOYER AND EMPLOYEE CONTRIBUTIONS MUST STAY IN PLAN.—Subsection (d) of section 409A (relating to employer securities must stay in plan) is amended by inserting "(or allocated to a participant's account in connection with matched employer and employee contributions)" after "under subsection (b)".

22 (G) CLERICAL AMENDMENTS.—

23 (i) Subparagraph (E) of section 46(a)(2) is amended by inserting "and ending on"

1 before "December 31, 1983" each place it
2 appears.
3 (ii) Subparagraph (B) of section 48(n)(2)
4 is amended by adding "and" at the end of
5 clause (i), by striking out clause (ii), and by
6 redesignating clause (iii) as clause (ii).
7 (iii) Paragraph (5) of section 48(o) is
8 amended by inserting "percentage" after
9 "attributable to the matching ESOP".
10 (7) AMENDMENT RELATED TO SECTION 142 OF
11 THE ACT.—Subsection (c) of section 691 (relating to
12 deduction for estate tax) is amended by adding at the
13 end thereof the following new paragraph:
14 "(5) COORDINATION WITH SECTION 402(e).—For
15 purposes of section 402(e) (other than paragraph (1)(D)
16 thereof), the total taxable amount of any lump sum dis-
17 tribution shall be reduced by the amount of the deduc-
18 tion allowable under paragraph (1) of this subsection
19 which is attributable to the total taxable amount (de-
20 termined without regard to this paragraph)."
21 (8) AMENDMENT RELATED TO SECTION 143 OF
22 THE ACT.—Subparagraph (B) of section 401(a)(22) is
23 amended by striking "as securities" and inserting in
24 lieu thereof "are securities".

1 (9) AMENDMENTS RELATED TO SECTION 152 OF
2 THE ACT.—
3 (A) CERTAIN EMPLOYEES MAY BE EX-
4 CLUDED.—Paragraph (2) of section 408(k) (relat-
5 ing to participation requirements for simplified
6 employee pension) is amended by adding at the
7 end thereof the following new sentence:
8 "For purposes of this paragraph, there shall be ex-
9 cluded from consideration employees described in sub-
10 paragraph (A) or (C) of section 410(b)(2)."
11 (B) CONTRIBUTIONS UNDER SIMPLIFIED
12 EMPLOYEE PENSION NOT SUBJECT TO FICA OR
13 FUTA TAXES.—
14 (i) FICA TAX.—Paragraph (5) of sec-
15 tion 3121(a) (defining wages) is amended by
16 striking out "or" at the end of subparagraph
17 (B), by striking out the semicolon at the end
18 of subparagraph (C) and inserting in lieu
19 thereof ", or", and by adding at the end
20 thereof the following new subparagraph:
21 "(D) under a simplified employee pension if,
22 at the time of the payment, it is reasonable to be-
23 lieve that the employee will be entitled to a de-
24 duction under section 219 for such payment;".

1 (ii) FUTA TAX.—Paragraph (5) of sec-
2 tion 3306(b) (defining wages) is amended by
3 striking out "or" at the end of subparagraph
4 (B), by striking out the semicolon at the end
5 of subparagraph (C) and inserting in lieu
6 thereof ", or", and by adding at the end
7 thereof the following new subparagraph:
8 "(D) under a simplified employee pension if,
9 at the time of the payment, it is reasonable to be-
10 lieve that the employee will be entitled to a de-
11 duction under section 219 for such payment;".
12 (C) CORRECTION OF CERTAIN EXCESS CON-
13 TRIBUTIONS.—Subparagraph (A) of section
14 408(d)(5) (relating to certain distributions of
15 excess contributions after due date for taxable
16 year) is amended by adding at the end thereof the
17 following new sentence:
18 "If employer contributions on behalf of the indi-
19 vidual are paid for the taxable year to a simplified
20 employee pension, the dollar limitation of the pre-
21 ceding sentence shall be increased by the lesser of
22 the amount of such contributions or $7,500."
23 (D) CLARIFICATION OF SECTION
24 219(b)(7).—Paragraph (7) of section 219(b) (relat-

1 ing to simplified employee pensions) is amended to
2 read as follows:
3 "(7) SPECIAL RULES IN CASE OF SIMPLIFIED
4 EMPLOYEE PENSIONS.—
5 "(A) LIMITATION.—If there is an employer
6 contribution on behalf of the employee to a simpli-
7 fied employee pension, the limitation under para-
8 graph (1) shall be the lesser of—
9 "(i) 15 percent of the compensation in-
10 cludible in the employee's gross income for
11 the taxable year (determined without regard
12 to the employer contribution to the simplified
13 employee pension), or
14 "(ii) the sum of—
15 "(I) the amount contributed by the
16 employer to the simplified employee
17 pension and included in gross income
18 (but not in excess of $7,500), and
19 "(II) $1,500, reduced (but not
20 below zero) by the amount described in
21 subclause (I).
22 "(B) CERTAIN LIMITATIONS DO NOT APPLY
23 TO EMPLOYER CONTRIBUTION.—Paragraphs (2)
24 and (3) shall not apply with respect to the em-

1 ployer contribution to a simplified employee
2 pension.
3 "(C) SPECIAL RULE FOR APPLYING SUB-
4 PARAGRAPH (A)(ii).—In the case of an employee
5 who is an officer, shareholder, or owner-employee
6 described in section 408(k)(3), the $7,500 amount
7 specified in subparagraph (A)(ii)(I) shall be re-
8 duced by the amount of tax taken into account
9 with respect to such individual under subpara-
10 graph (D) of section 408(k)(3)."
11 (E) COORDINATION WITH PLAN FOR
12 SHAREHOLDER-EMPLOYEES.—Paragraph (4) of
13 section 404(h) (relating to effect on self-employed
14 individuals) is amended—
15 (i) by inserting "or described in section
16 1379(b)(1)" after "of subsection (e)",
17 (ii) by inserting "or a shareholder-em-
18 ployee (as defined in section 1379(d))" after
19 "section 401(c)(1)", and
20 (iii) by striking out "SELF-EMPLOYED
21 INDIVIDUALS" in the paragraph heading and
22 inserting in lieu thereof "SELF-EMPLOYED
23 INDIVIDUALS OR SHAREHOLDER-EMPLOY-
24 EES".

1 (F) COORDINATION WITH SECTION 401(j).—
2 Subsection (k) of section 408 (defining simplified
3 employee pension) is amended—
4 (i) by striking out "and (5)" in para-
5 graph (1) and inserting in lieu thereof "(5),
6 and (6)",
7 (ii) by redesignating paragraph (6) as
8 paragraph (7), and
9 (iii) by inserting after paragraph (5) the
10 following new paragraph:
11 "(6) EMPLOYER MAY NOT MAINTAIN PLAN TO
12 WHICH SECTION 401(j) APPLIES.—The requirements
13 of this paragraph are met with respect to a simplified
14 employee pension for a calendar year unless the em-
15 ployer maintains during any part of such year a plan—
16 "(A) some or all of the active participants in
17 which are employees (within the meaning of sec-
18 tion 401(c)(1)) or shareholder-employees (as de-
19 fined in section 1379(d)), and
20 "(B) to which section 401(j) applies."
21 (G) CLERICAL AMENDMENTS.—
22 (i) Subsection (j) of section 408 is
23 amended by inserting "and" at the end of
24 paragraph (1), by striking out ", and" at the
25 end of paragraph (2) and inserting in lieu

1 thereof a period, and by striking out para-
2 graph (3).
3 (ii) Paragraphs (2), (3), and (4) of sec-
4 tion 404(h) are each amended by striking out
5 "subparagraph (1)" each place it appears
6 and inserting in lieu thereof "paragraph (1)".
7 (iii) Paragraph (2) of section 152(g) of
8 the Revenue Act of 1978 is amended by
9 striking out "section 415(b)(2)" and inserting
10 in lieu thereof "section 415(a)(2)".
11 (10) AMENDMENTS RELATED TO SECTION 153
12 OF THE ACT.—
13 (A) WAIVER OF SECTION 415(b)(1)(B) LIMI-
14 TATION DOES NOT APPLY WHERE PARTICIPANT
15 IS ALSO A PARTICIPANT OF ANOTHER QUALI-
16 FIED PLAN.—Paragraph (7) of section 415(b) (re-
17 lating to benefits under certain collectively bar-
18 gained plans) is amended by inserting after the
19 second sentence the following new sentence:
20 "This paragraph shall not apply to a participant
21 for any period for which he is a participant under
22 another plan to which this section applies which is
23 maintained by an employer maintaining this
24 plan."

1 (B) FORMULA FOR DETERMINING BENEFITS
2 IN THE CASE OF SECTION 415(b)(7) PLANS.—
3 Subparagraph (C) of section 415(b)(7) is amended
4 to read as follows:
5 "(C) under which benefits are determined
6 solely by reference to length of service, the partic-
7 ular years during which service was rendered, age
8 at retirement, and date of retirement,"
9 (11) AMENDMENT RELATED TO SECTION 154 OF
10 THE ACT.—Subparagraph (A) of section 403(b)(7) is
11 amended by striking out "which satisfied" and insert-
12 ing in lieu thereof "which satisfies".
13 (12) AMENDMENT RELATED TO SECTION 156 OF
14 THE ACT.—
15 (A) EFFECTIVE DATE.—Subsection (d) of
16 section 156 of the Revenue Act of 1978 (relating
17 to effective date for provision allowing rollover of
18 section 403(b) annuities) is amended by striking
19 out "December 31, 1978" and inserting in lieu
20 thereof "December 31, 1977".
21 (B) TRANSITIONAL RULE FOR MAKING SEC-
22 TION 403(b)(8) ROLLOVER IN THE CASE OF PAY-
23 MENTS DURING 1978.—In the case of any pay-
24 ment made during 1978 in a qualifying distribu-
25 tion described in section 403(b)(8) of the Internal

1 Revenue Code of 1954, the applicable period
2 specified in section 402(a)(5)(C) of such Code shall
3 not expire before the close of December 31, 1980.
4 (C) CLERICAL AMENDMENTS.—Sections
5 403(b)(1) and 4973(c)(1) are each amended by
6 striking out "409(d)(3)(C)", and inserting in lieu
7 thereof "409(b)(3)(C)".
8 (13) AMENDMENTS RELATED TO SECTION 157
9 OF THE ACT.—
10 (A) EFFECTIVE DATE FOR REMOVAL OF
11 CERTAIN REQUIREMENTS.—Paragraph (3) of sec-
12 tion 157(h) of the Revenue Act of 1978 is
13 amended by striking out "the amendments made
14 by this section" each place it appears and insert-
15 ing in lieu thereof "the amendments made by this
16 subsection".
17 (B) CONFORMING AMENDMENTS FOR SPOU-
18 SAL ROLLOVERS.—Sections 219(b)(4), 220(b)(5),
19 408(a)(1), 409(a)(4), and 4973(b)(1)(A) are each
20 amended by inserting "402(a)(7)," after "section
21 402(a)(5),".
22 (C) SPOUSAL ROLLOVERS.—Clause (i) of
23 section 402(a)(7)(A) is amended to read as fol-
24 lows:

1 "(i) any portion of a qualifying rollover
2 distribution attributable to an employee is
3 paid to the spouse of the employee after the
4 employee's death,".
5 (D) EXTENSION OF TRANSITIONAL RULE.—
6 Subparagraph (B) of section 157(h)(3) of the Rev-
7 enue Act of 1978 (relating to transitional rule for
8 removal of certain requirements) is amended—
9 (i) by striking out "any payment" and
10 inserting in lieu thereof "any payment made
11 during 1978", and
12 (ii) by striking out "December 31,
13 1978" and inserting in lieu thereof "Decem-
14 ber 31, 1980".
15 (E) CLERICAL AMENDMENTS.—
16 (i) Clause (iii) of section 402(a)(6)(D)
17 (relating to sales of distributed property) is
18 amended by striking out "many designate"
19 and inserting in lieu thereof "may desig-
20 nate".
21 (ii) Subparagraph (B) of section
22 408(d)(5) is amended by striking out all that
23 follows clause (i) and inserting in lieu thereof
24 the following:
25 "(ii) the information was erroneous,

1 subparagraph (A) shall be applied by increasing
2 the dollar limit set forth therein by that portion of
3 the excess contribution which was attributable to
4 such information."
5 (b) EFFECTIVE DATES.—
6 (1) SPECIAL EFFECTIVE DATES.—
7 (A) SUBSECTION (a)(1).—The amendment
8 made by subsection (a)(1) shall apply to taxable
9 years beginning after December 31, 1977.
10 (B) SUBSECTION (a)(2).—The amendments
11 made by subparagraphs (A) and (B) of subsection
12 (a)(2) shall apply to payments for months begin-
13 ning after December 31, 1979.
14 (C) DEFINITION OF QUALIFYING EMPLOYER
15 SECURITIES.—The amendment made by subpara-
16 graph (C) of subsection (a)(6) shall apply to stock
17 acquired after December 31, 1979.
18 (D) COORDINATION WITH SECTION 691.—
19 The amendment made by subsection (a)(7) shall
20 apply with respect to the estates of decedents
21 dying after the date of the enactment of this Act.
22 (E) CONTRIBUTIONS UNDER SIMPLIFIED
23 EMPLOYEE PENSION.—The amendments made by
24 subparagraph (B) of subsection (a)(9) shall apply
25 to payments made on or after January 1, 1979.

1 (2) GENERAL EFFECTIVE DATE.—

For general effective date, see section 201.

2 **SEC. 102. AMENDMENTS RELATED TO TITLE II.**

3 (a) GENERAL RULE.—

4 (1) AMENDMENTS RELATED TO SUBTITLE A OF
5 TITLE II OF THE ACT.—

6 (A) STOCK OWNERSHIP RULES.—Subsection
7 (a) of section 465 (relating to deductions limited
8 to amount at risk) is amended—

9 (i) by striking out "(determined by ref-
10 erence to the rules contained in section 318
11 rather than under section 544)" in paragraph
12 (1)(C), and

13 (ii) by adding at the end thereof the fol-
14 lowing new paragraph:

15 "(3) SPECIAL RULES FOR APPLYING PARAGRAPH
16 (1)(C).—For purposes of paragraph (1)(C)—

17 "(A) section 544(a)(2) shall be applied as if
18 such section did not contain the phrase 'or by or
19 for his partner'; and

20 "(B) sections 544(a)(4)(A) and 544(b)(1) shall
21 be applied by substituting 'the corporation meet
22 the stock ownership requirements of section
23 542(a)(2)' for 'the corporation a personal holding
24 company'."

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1 (B) CLARIFICATION OF RULES FOR RECAP-
2 TURE OF LOSSES WHERE AMOUNT AT RISK IS
3 LESS THAN ZERO.—Subsection (d) of section 465
4 (defining loss) is amended by inserting before the
5 period at the end thereof the following: "(deter-
6 mined without regard to subsection (e)(1)(A))".
7 (C) CLARIFICATION OF LIMITATION ON RE-
8 CAPTURE OF LOSSES.—Subparagraph (A) of sec-
9 tion 465(e)(2) (relating to limitation on recapture
10 of losses where amount at risk is less than zero)
11 is amended by inserting "by reason of losses"
12 after "with respect to the activity".
13 (D) EXCLUSION FOR CERTAIN EQUIPMENT
14 LEASING BY CLOSELY-HELD CORPORATIONS.—
15 (i) Subsection (c) of section 465 (relat-
16 ing to deductions limited to amount at risk)
17 is amended by adding at the end thereof the
18 following new paragraphs:
19 "(4) EXCLUSION FOR CERTAIN EQUIPMENT
20 LEASING BY CLOSELY-HELD CORPORATIONS.—
21 "(A) IN GENERAL.—In the case of a corpo-
22 ration described in subsection (a)(1)(C) actively
23 engaged in equipment leasing—
24 "(i) the activity of equipment leasing
25 shall be treated as a separate activity, and

1 "(ii) subsection (a) shall not apply to
2 losses from such activity.
3 "(B) 50-PERCENT GROSS RECEIPTS TEST.—
4 For purposes of subparagraph (A), a corporation
5 shall not be considered to be actively engaged in
6 equipment leasing unless 50 percent or more of
7 the gross receipts of the corporation for the tax-
8 able year is attributable, under regulations pre-
9 scribed by the Secretary, to equipment leasing.
10 "(C) COMPONENT MEMBERS OF CON-
11 TROLLED GROUP TREATED AS A SINGLE CORPO-
12 RATION.—For purposes of subparagraph (A), the
13 component members of a controlled group of cor-
14 porations shall be treated as a single corporation.
15 "(5) WAIVER OF CONTROLLED GROUP RULE
16 WHERE THERE IS SUBSTANTIAL LEASING ACTIVI-
17 TY.—
18 "(A) IN GENERAL.—In the case of the com-
19 ponent members of a qualified leasing group,
20 paragraph (4) shall be applied—
21 "(i) by substituting '80 percent' for '50
22 percent' in subparagraph (B) thereof, and
23 "(ii) as if paragraph (4) did not include
24 subparagraph (C) thereof.

1 "(B) QUALIFIED LEASING GROUP.—For
2 purposes of this paragraph, the term 'qualified
3 leasing group' means a controlled group of corpo-
4 rations which, for the taxable year and each of
5 the 2 immediately preceding taxable years, satis-
6 fied each of the following 3 requirements:
7 "(i) AT LEAST 3 EMPLOYEES.—During
8 the entire year, the group had at least 3 full-
9 time employees substantially all of the serv-
10 ices of whom were services directly related
11 to the equipment leasing activity of the
12 qualified leasing members.
13 "(ii) AT LEAST 5 SEPARATE LEASING
14 TRANSACTIONS.—During the year, the
15 qualified leasing members in the aggregate
16 entered into at least 5 separate equipment
17 leasing transactions.
18 "(iii) AT LEAST $1,000,000 EQUIP-
19 MENT LEASING RECEIPTS.—During the
20 year, the qualified leasing members in the
21 aggregate had at least $1,000,000 in gross
22 receipts from equipment leasing.
23 The term 'qualified leasing group' does not in-
24 clude any controlled group of corporations to

1 which, without regard to this paragraph, para-
2 graph (4) applies.
3 "(C) QUALIFIED LEASING MEMBER.—For
4 purposes of this paragraph, a corporation shall be
5 treated as a qualified leasing member for the tax-
6 able year only if for each of the taxable years re-
7 ferred to in subparagraph (B)—
8 "(i) it is a component member of the
9 controlled group of corporations, and
10 "(ii) it meets the requirements of para-
11 graph (4)(B) (as modified by subparagraph
12 (A)(i) of this paragraph).
13 "(6) DEFINITIONS RELATING TO PARAGRAPHS
14 (4) AND (5).—For purposes of paragraphs (4) and (5)—
15 "(A) EQUIPMENT LEASING.—The term
16 'equipment leasing' means—
17 "(i) the leasing of equipment which is
18 section 1245 property, and
19 "(ii) the purchasing, servicing, and sell-
20 ing of such equipment.
21 "(B) LEASING OF MASTER SOUND RECORD-
22 INGS, ETC., EXCLUDED.—The term 'equipment
23 leasing' does not include the leasing of master
24 sound recordings, and other similar contractual
25 arrangements with respect to tangible or intangi-

1 ble assets associated with literary, artistic, or
2 musical properties.
3 "(C) CONTROLLED GROUP OF CORPORA-
4 TIONS; COMPONENT MEMBER.—The terms 'con-
5 trolled group of corporations' and 'component
6 member' have the same meanings as when used
7 in section 1563. The determination of the taxable
8 years taken into account with respect to any con-
9 trolled group of corporations shall be made in a
10 manner consistent with the manner set forth in
11 section 1563."
12 (ii) Subparagraph (D) of section
13 465(c)(3) is amended to read as follows:
14 "(D) EXCLUSION FOR REAL PROPERTY.—In
15 the case of activities described in subparagraph
16 (A), the holding of real property (other than min-
17 eral property) shall be treated as a separate activ-
18 ity, and subsection (a) shall not apply to losses
19 from such activity. For purposes of the preceding
20 sentence, personal property and services which
21 are incidental to making real property available as
22 living accommodations shall be treated as part of
23 the activity of holding such real property."
24 (iii) Paragraph (5) of section 465(b) is
25 amended by striking out "to which this sec-

1 tion applies" and inserting in lieu thereof "to
2 which subsection (a) applies".
3 (E) CLERICAL AMENDMENT TO EFFECTIVE
4 DATE.—Subparagraph (A) of section 204(b)(2) of
5 the Revenue Act of 1978 (relating to special tran-
6 sitional rules for leasing activities) is amended by
7 striking out "this section" and inserting in lieu
8 thereof "this subtitle".
9 (2) AMENDMENTS RELATED TO SUBTITLE B OF
10 TITLE II OF THE ACT.—
11 (A) AMENDMENT OF SECTION 6501.—Sec-
12 tion 6501 (relating to limitations on assessment
13 and collection) is amended by redesignating the
14 subsection added by section 212(a) of the Revenue
15 Act of 1978 as subsection (o).
16 (B) AMENDMENT OF SECTION 6511(g)(2).—
17 Paragraph (2) of section 6511(g) (relating to spe-
18 cial rule for partnership items of federally regis-
19 tered partnerships) is amended by striking out
20 "6501(q)" and inserting in lieu thereof "6501(o)".
21 (b) EFFECTIVE DATE.—

For general effective date, see section 201.

22 **SEC. 103. AMENDMENTS RELATED TO TITLE III.**
23 (a) GENERAL RULE.—

1 (1) AMENDMENTS RELATED TO SECTION 312 OF
2 THE ACT.—
3 (A) CLARIFICATION OF FLOW-THROUGH
4 PROVISIONS.—Paragraph (2) of section 312(c) of
5 the Revenue Act of 1978 (relating to repeal of
6 certain obsolete provisions) is amended to read as
7 follows:
8 "(2) Paragraphs (1) and (2) of section 46(f) and
9 subparagraph (B) of section 48(a)(7) are each amended
10 by striking out 'described in section 50' and inserting
11 in lieu thereof 'described in section 50 (as in effect
12 before its repeal by the Revenue Act of 1978)'."
13 (B) CLERICAL AMENDMENTS TO SPECIAL
14 RULES FOR ENERGY PROPERTY.—
15 (i) Subsection (a) of section 46 (relating
16 to amount of investment credit) is amended
17 by redesignating paragraph (10) as para-
18 graph (9).
19 (ii) Clause (i) of section 46(a)(9)(B) (as
20 redesignated by clause (i)) is amended to
21 read as follows:
22 "(i) paragraph (3)(B) shall be applied by
23 substituting '100 percent' for the percentage
24 determined under the table contained in such
25 paragraph,".

1 (iii) Clause (ii) of section 46(a)(9)(B) (as
2 so redesignated) is amended by striking out
3 "(7), (8), and (9)" and inserting in lieu there-
4 of "(7) and (8)".
5 (iv) Subsection (d) of section 6401 is
6 amended by striking out "46(a)(10)(C)" and
7 inserting in lieu thereof "46(a)(9)(C)".
8 (2) AMENDMENT RELATED TO SECTION 313 OF
9 THE ACT.—Subparagraph (B) of section 46(c)(5) (relat-
10 ing to applicable percentage in the case of certain pol-
11 lution control facilities) is amended by adding at the
12 end thereof the following new sentence: "This subpara-
13 graph shall not apply for purposes of applying the
14 energy percentage."
15 (3) AMENDMENTS RELATED TO SECTION 315 OF
16 THE ACT.—
17 (A) CREDIT ALLOWED TO NONCORPORATE
18 LESSORS.—Paragraph (3) of section 46(e) (relat-
19 ing to special rule for noncorporate lessors) is
20 amended by adding at the end thereof the follow-
21 ing new sentence: "This paragraph shall not
22 apply with respect to any property which is treat-
23 ed as section 38 property by reason of section
24 48(a)(1)(E)."

1 (B) COORDINATION WITH ENERGY PROP-
2 ERTY.—Clause (i) of section 48(g)(2)(B) is amend-
3 ed by striking out "subsection (a)(1)(E)" and in-
4 serting in lieu thereof "subsections (a)(1)(E) and
5 (l))".
6 (4) AMENDMENT RELATED TO SECTION 316 OF
7 THE ACT.—Sections 50B(f) and 52(f) are each
8 amended by striking out "section 46(e)" and inserting
9 in lieu thereof "subsections (e) and (h) of section 46".
10 (5) AMENDMENTS RELATED TO SECTION 321 OF
11 THE ACT.—
12 (A) EXTENSION OF TERMINATION DATE.—
13 Paragraph (4) of section 51(c) (relating to termi-
14 nation) is amended by striking out "December 31,
15 1980" and inserting in lieu thereof "December
16 31, 1981".
17 (B) EFFECTIVE DATE FOR PROVISION
18 MAKING NEW JOBS CREDIT ELECTIVE.—Subsec-
19 tion (d) of section 321 of the Revenue Act of
20 1978 (relating to effective dates) is amended by
21 adding at the end thereof the following new para-
22 graph:
23 "(5) SUBSECTION (b).—The amendments made by
24 subsection (b) shall apply to taxable years beginning
25 after December 31, 1976."

1 (C) CLARIFICATION OF EFFECTIVE DATE.—
2 Subparagraph (A) of section 321(d)(2) of the Rev-
3 enue Act of 1978 (relating to special rules for
4 newly targeted groups) is amended by inserting ",
5 for purposes of applying the amendments made by
6 this section" after "newly targeted group".
7 (D) CLARIFICATION OF TRANSITIONAL
8 RULE.—Paragraph (3) of section 321(d) of the
9 Revenue Act of 1978 (relating to transitional rule)
10 is amended to read as follows:
11 "(3) TRANSITIONAL RULE.—In the case of a tax-
12 able year which begins in 1978 and ends after Decem-
13 ber 31, 1978, the amount of the credit determined
14 under section 51 of the Internal Revenue Code of
15 1954 shall be the sum of—
16 "(A) the amount of the credit which would
17 be so determined without regard to the amend-
18 ments made by this section, plus
19 "(B) the amount of the credit which would
20 be so determined by reason of the amendments
21 made by this section."
22 (E) FUTA WAGES TO BE TREATED AS IN-
23 CLUDING REMUNERATION OF YOUTH PARTICI-
24 PATING IN A COOPERATIVE EDUCATION
25 PROGRAM.—

1 (i) Subparagraph (D) of section 51(d)(8)
2 (relating to members of targeted groups) is
3 amended to read as follows:
4 "(D) WAGES.—In the case of remuneration
5 attributable to services performed while the indi-
6 vidual meets the requirements of subparagraph
7 (A), wages, and unemployment insurance wages,
8 shall be determined without regard to section
9 3306(c)(10)(C)."
10 (ii) Paragraph (1) of section 51(c) (defin-
11 ing wages) is amended by striking out "and
12 subsection (h)(2)," and inserting in lieu there-
13 of ", subsection (d)(8)(D), and subsection
14 (h)(2),".
15 (F) CLERICAL AMENDMENTS.—
16 (i) Subsection (a) of section 44B is
17 amended by striking out "at the taxpayer"
18 and inserting in lieu thereof "of the tax-
19 payer".
20 (ii) Paragraph (2) of section 44B(c) is
21 amended by striking out "may be" and in-
22 serting in lieu thereof "may by".
23 (iii) Paragraph (2) of section 51(c) is
24 amended by striking out "amounts paid" and

1 inserting in lieu thereof "amounts paid or in-
2 curred".
3 (iv) Paragraph (1) of section 51(d) is
4 amended by striking out "or" at the end of
5 subparagraph (E).
6 (v) Clause (i) of section 51(d)(4)(A) is
7 amended by striking out "active day" and
8 inserting in lieu thereof "active duty".
9 (vi) Subparagraph (B) of section 51(d)(4)
10 is amended by striking out "premployment"
11 and inserting in lieu thereof "preemploy-
12 ment".
13 (vii) Paragraph (5) of section 51(d) is
14 amended by striking out "pre-employment"
15 and inserting in lieu thereof "preemploy-
16 ment".
17 (viii) Paragraph (12) of section 51(d) is
18 amended by striking out "employer" and in-
19 serting in lieu thereof "employers".
20 (ix) The last sentence of section 51(e) is
21 amended by inserting "except as provided in
22 subsection (h)(1)," after "the preceding sen-
23 tence,".
24 (x) Section 6501 is amended by redesig-
25 nating the subsection added by section

1 321(b)(2) of the Revenue Act of 1978 as
2 subsection (p).
3 (xi) Subparagraph (B) of section
4 321(d)(2) of the Revenue Act of 1978 is
5 amended by striking out clauses (i) and (ii)
6 and inserting in lieu thereof the following:
7 "(i) such individual meets the require-
8 ments of paragraph (1) of section 51(d) of
9 such Code, and
10 "(ii) in the case of an individual meeting
11 the requirements of subparagraph (A) of such
12 paragraph (1), a credit was not claimed for
13 such individual by the taxpayer for a taxable
14 year beginning before January 1, 1979."
15 (xii) Paragraph (4) of section 321(d) of
16 the Revenue Act of 1978 is amended by
17 striking out "subsection (u)(2)" and inserting
18 in lieu thereof "subsection (c)(2)".
19 (xiii) Section 383 and subsection (a) of
20 section 6411 are each amended by striking
21 out "section 53(c)" and inserting in lieu
22 thereof "section 53(b)".
23 (6) AMENDMENTS RELATED TO SECTION 322 OF
24 THE ACT.—

1 (A) CLARIFICATION OF EFFECTIVE DATE.—
2 Paragraph (1) of section 322(e) of the Revenue
3 Act of 1978 (relating to effective date) is amended
4 by adding at the end thereof the following new
5 sentence: "For purposes of applying section
6 50A(a)(2) of the Internal Revenue Code of 1954
7 with respect to a taxable year beginning before
8 January 1, 1979, the rules of sections 50A(a)(4),
9 50A(a)(5), and 50B(e)(3) of such Code (as in effect
10 on the day before the date of the enactment of
11 this Act) shall apply."
12 (B) TRANSITIONAL RULE FOR EMPLOYEES
13 HIRED AFTER SEPTEMBER 26, 1978.—Subpara-
14 graph (B) of section 322(e)(2) of the Revenue Act
15 of 1978 (relating to eligible employees hired after
16 September 26, 1978) is amended—
17 (i) by striking out "September 27,
18 1978," and inserting in lieu thereof "Sep-
19 tember 26, 1978, for purposes of applying
20 the amendments made by this section,"; and
21 (ii) by striking out "January 1, 1979."
22 and inserting in lieu thereof "January 1,
23 1979, and any wages paid or incurred after
24 December 31, 1978, with respect to such in-

1 dividual shall be considered to be attributable
2 to services rendered after that date."
3 (C) CLERICAL AMENDMENTS.—
4 (i) Subparagraph (C) of section
5 50A(a)(4) (relating to limitation with respect
6 to nonbusiness eligible employees) is
7 amended by striking out " '$6,000' and" in-
8 serting in lieu thereof " '$6,000' for".
9 (ii) Subparagraph (B) of section
10 50B(g)(2) is amended by striking out "giving
11 to such credit" and inserting in lieu thereof
12 "giving rise to such credit".
13 (iii) Clause (i) of section 50B(h)(1)(A) is
14 amended by striking out "9-day" and insert-
15 ing in lieu thereof "90-day".
16 (iv) The second subsection designated as
17 subsection (d) of section 322 of the Revenue
18 Act of 1978 is amended by striking out
19 "our" in paragraph (1)(A) thereof and insert-
20 ing in lieu thereof "out".
21 (7) AMENDMENT RELATING TO SECTION 345 OF
22 THE ACT.—Subsection (e) of section 345 of the Reve-
23 nue Act of 1978 (relating to effective date for small
24 business corporation stock provision) is amended to
25 read as follows:

1 "(e) EFFECTIVE DATES.—
2 "(1) IN GENERAL.—Except as provided in para-
3 graph (2), the amendments made by this section shall
4 apply to stock issued after November 6, 1978.
5 "(2) SUBSECTION (b).—The amendments made by
6 subsection (b) shall apply to taxable years beginning
7 after December 31, 1978.
8 "(3) TRANSITIONAL RULE FOR SUBSECTION
9 (b).—In the case of a taxable year which includes No-
10 vember 6, 1978, the amendments made by subsection
11 (b) shall apply with respect to stock issued after such
12 date."
13 (8) AMENDMENTS RELATED TO SECTION 361 OF
14 THE ACT.—
15 (A) OTHER CLUBS.—Subparagraph (C) of
16 section 274(a)(2) (relating to special rule for coun-
17 try clubs) is amended by striking out "country".
18 (B) CLERICAL AMENDMENT.—Subsection (b)
19 of section 361 of the Revenue Act of 1978 is
20 amended—
21 (i) by striking out "section 274(2)" and
22 inserting in lieu thereof "section 274(a)",
23 and
24 (ii) by striking out "COUNTRY" in the
25 subsection heading.

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1 (9) AMENDMENTS RELATED TO SECTION 362 OF
2 THE ACT.—
3 (A) Subsection (e) of section 362 of the Rev-
4 enue Act of 1978 (relating to effective date for
5 deficiency dividend procedure for regulated invest-
6 ment companies) is amended by striking out
7 "860(d)" and inserting in lieu thereof "860(e)".
8 (B) The subsection heading of subsection (f)
9 of section 860 is amended by striking out
10 "EFFICIENCY" and inserting in lieu thereof
11 "DEFICIENCY".
12 (C) Clause (i) of section 860(f)(2)(A) is
13 amended by striking out "computed without
14 regard" and inserting in lieu thereof "(computed
15 without regard".
16 (10) AMENDMENTS RELATED TO SECTION 366
17 OF THE ACT.—
18 (A) WITHHOLDING.—Subsection (a) of sec-
19 tion 3401 (defining wages) is amended—
20 (i) by striking out "or" at the end of
21 paragraph (17),
22 (ii) by striking out the period at the end
23 of the paragraph (18) added by section
24 207(a) of the Foreign Earned Income Act of
25 1978 and inserting in lieu thereof "; or",

1 (iii) by redesignating the paragraph (18)
2 added by section 164(b)(1) of the Revenue
3 Act of 1978 as paragraph (19), and
4 (iv) by striking out "section 124" in
5 paragraph (19) (as so redesignated) and in-
6 serting in lieu thereof "section 105 or 127".
7 (B) CLARIFICATION OF NONDISCRIMINA-
8 TORY ELIGIBILITY CLASSIFICATIONS.—Clause
9 (ii) of section 105(h)(3)(A) is amended by striking
10 out "highly compensated participants" and in-
11 serting in lieu thereof "highly compensated
12 individuals".
13 (C) CLARIFICATION OF EXCESS REIM-
14 BURSEMENT OF HIGHLY COMPENSATED INDIVID-
15 UALS.—Subparagraph (A) of section 105(h)(7) is
16 amended to read as follows:
17 "(A) in the case of a benefit available to
18 highly compensated individuals but not to all
19 other participants (or which otherwise fails to sat-
20 isfy the requirements of paragraph (2)(B)), the
21 amount reimbursed under the plan to the em-
22 ployee with respect to such benefit, and".
23 (D) CLARIFICATION OF EFFECTIVE DATE.—
24 Subsection (b) of section 366 of the Revenue Act
25 of 1978 is amended to read as follows:

1 "(b) EFFECTIVE DATE.—The amendment made by this
2 section shall apply to amounts reimbursed after December
3 31, 1979."
4 (11) AMENDMENT RELATED TO SECTION 369 OF
5 THE ACT.—Clause (iv) of section 374(e)(1)(A) (relating
6 to use of expired net operating loss carryovers to offset
7 income arising from certain railroad reorganization pro-
8 ceedings) is amended by striking out "March 31,
9 1967" and inserting in lieu thereof "March 31, 1976".
10 (12) AMENDMENT RELATED TO SECTION 371 OF
11 THE ACT.—Paragraph (2) of section 371(a) of the
12 Revenue Act of 1978 (relating to net operating losses
13 attributable to product liability losses) is amended by
14 striking out "Clause (i) of section 172(b)(1)(A)" and in-
15 serting in lieu thereof "Subparagraph (A) of section
16 172(b)(1)".
17 (13) AMENDMENT RELATED TO SECTION 373 OF
18 THE ACT.—Subparagraph (B) of section 466(e)(2) (re-
19 lating to initial opening balance of suspense account) is
20 amended by striking out "first taxable years" and in-
21 serting in lieu thereof "first taxable year".
22 (b) EFFECTIVE DATE.—

For general effective date, see section 201.

23 **SEC. 104. AMENDMENTS RELATED TO TITLE IV.**
24 (a) IN GENERAL.—

1 (1) AMENDMENT RELATED TO SECTION 401 OF
2 THE ACT.—Subsection (b) of section 877 is amended
3 by striking out "402(e)(1), or section 1201(b)" and in-
4 serting in lieu thereof "or 402(e)(1)".
5 (2) AMENDMENTS RELATED TO SECTION 402 OF
6 THE ACT.—
7 (A) AMENDMENTS OF TRANSITIONAL
8 RULE.—Subsection (c) of section 1202 (relating to
9 transitional rule of taxable years which include
10 November 1, 1978) is amended—
11 (i) by striking out so much of such sub-
12 section as precedes "a taxpayer other than a
13 corporation" and inserting in lieu thereof:
14 "(c) TRANSITIONAL RULE.—If for any taxable year
15 ending after October 31, 1978, and beginning before Novem-
16 ber 1, 1979,"; and
17 (ii) by amending subparagraph (B) of
18 paragraph (1) to read as follows:
19 "(B) the net capital gain taking into account
20 only gain or loss properly taken into account for
21 the portion of the taxable year after October 31,
22 1978, plus".
23 (B) COMPUTATION OF MAXIMUM 25 PER-
24 CENT ALTERNATIVE CAPITAL GAINS TAX FOR
25 1978.—

1 (i) Paragraph (1) of section 1201(b) (as
2 such paragraph was in effect for taxable
3 years beginning before January 1, 1979) is
4 amended by striking out "50 percent of the
5 net capital gain" and inserting in lieu thereof
6 "the excess of the net capital gain over the
7 deduction under section 1202".
8 (ii) Subsection (c) of section 1201 (as
9 such subsection was in effect for taxable
10 years beginning before January 1, 1979) is
11 amended to read as follows:
12 "(c) COMPUTATION OF TAX WHERE CAPITAL GAIN
13 EXCEEDS $50,000.—The tax computed for purposes of sub-
14 section (b)(3) shall be the amount by which a tax determined
15 under section 1 or 511 on an amount equal to the taxable
16 income (but not less than the excess of the net capital gain
17 over the deduction under section 1202) for the taxable year
18 exceeds a tax determined under section 1 or 511 on an
19 amount equal to the sum of—
20 "(1) the amount subject to tax under subsection
21 (b)(1), plus
22 "(2) an amount determined by multiplying the
23 sum referred to in subsection (b)(2)(A) by a fraction—

1 "(A) the numerator of which is the excess of
2 the net capital gain over the deduction under sec-
3 tion 1202, and
4 "(B) the denominator of which is the net
5 capital gain."
6 (C) SPECIAL RULE FOR PASS-THROUGH
7 ENTITIES.—
8 (i) IN GENERAL.—In applying sections
9 1201(c)(2)(A)(ii) and 1202(c)(1)(B) of the In-
10 ternal Revenue Code of 1954 with respect to
11 any pass-through entity, the determination of
12 the period for which gain or loss is properly
13 taken into account shall be made at the
14 entity level.
15 (ii) PASS-THROUGH ENTITY DE-
16 FINED.—For purposes of clause (i), the term
17 "pass-through entity" means—
18 (I) a regulated investment com-
19 pany,
20 (II) a real estate investment trust,
21 (III) an electing small business
22 corporation,
23 (IV) a partnership,
24 (V) an estate or trust, and
25 (VI) a common trust fund.

1 (3) AMENDMENTS RELATED TO SECTION 403 OF
2 THE ACT.—
3 (A) CLARIFICATION OF TRANSITIONAL
4 RULE.—Subsection (c) of section 1201 (relating to
5 transitional rule for taxable years which include
6 January 1, 1979) is amended—
7 (i) by striking out so much of such sec-
8 tion as precedes "a corporation" and insert-
9 ing in lieu thereof the following:
10 "(c) TRANSITIONAL RULE.—If for any taxable year
11 ending after December 31, 1978, and beginning before Janu-
12 ary 1, 1980,", and
13 (ii) by amending clause (ii) of paragraph
14 (2)(A) to read as follows:
15 "(ii) the net capital gain taking into ac-
16 count only gain or loss properly taken into
17 account for the portion of the taxable year
18 after December 31, 1978, plus".
19 (B) UNDISTRIBUTED CAPITAL GAIN OF REG-
20 ULATED INVESTMENT COMPANY.—Clause (iii) of
21 section 852(b)(3)(D) (relating to treatment by
22 shareholders of undistributed capital gain) is
23 amended by striking out "70 percent" and insert-
24 ing in lieu thereof "72 percent".

1 (C) ADDITION TO RESERVES FOR BAD
2 DEBTS.—Clause (iv) of section 593(b)(2)(E) is
3 amended by striking out "3/8" each place it ap-
4 pears and inserting in lieu thereof "18/46".
5 (D) CLERICAL AMENDMENTS.—
6 (i) Paragraph (3) of section 904(b) is
7 amended by redesignating the subparagraph
8 (E) added by section 403(c)(4) of the Reve-
9 nue Act of 1978 as subparagraph (F).
10 (ii) Subparagraph (B) of section
11 403(c)(4) of the Revenue Act of 1978 is
12 amended by striking out "striking the period
13 at the end of subparagraph (D) of paragraph
14 (3), inserting in lieu thereof a comma, and
15 inserting immediately thereafter" and insert-
16 ing in lieu thereof "adding at the end of
17 paragraph (3)".
18 (4) AMENDMENTS RELATED TO SECTION 421 OF
19 THE ACT.—
20 (A) CERTAIN DEDUCTIONS WHICH MAY BE
21 CARRIED OVER NOT TAKEN INTO ACCOUNT.—
22 Paragraph (1) of section 55(b) (defining alternative
23 minimum taxable income) is amended by adding
24 at the end thereof the following new sentence:

1 "For purposes of subparagraph (A), a deduction shall
2 not be taken into account to the extent such deduction
3 may be carried to another taxable year."
4 (B) TREATMENT OF FOREIGN TAX
5 CREDIT.—Paragraphs (1) and (2) of section 55(c)
6 (relating to credits) are amended to read as fol-
7 lows:
8 "(1) CREDITS OTHER THAN FOREIGN TAX
9 CREDIT NOT ALLOWABLE, ETC.—For purposes of de-
10 termining the amount of any credit allowable under
11 subpart A of part IV of this subchapter (other than the
12 foreign tax credit allowed under section 33(a))—
13 "(A) the tax imposed by this section shall
14 not be treated as a tax imposed by this chapter,
15 and
16 "(B) the amount of the foreign tax credit al-
17 lowed under section 33(a) shall be determined
18 without regard to this section.
19 "(2) FOREIGN TAX CREDIT ALLOWED AGAINST
20 ALTERNATIVE MINIMUM TAX.—
21 "(A) DETERMINATION OF FOREIGN TAX
22 CREDIT.—The total amount of the foreign tax
23 credit which can be taken against the tax imposed
24 by subsection (a) shall be determined under sub-

1 part A of part III of subchapter N (sec. 901 and
2 following).
3 "(B) INCREASE IN AMOUNT OF FOREIGN
4 TAXES TAKEN INTO ACCOUNT.—For purposes of
5 the determination provided by subparagraph (A),
6 the amount of taxes paid or accrued to foreign
7 countries or possessions of the United States
8 during the taxable year shall be increased by an
9 amount equal to the lesser of—
10 "(i) the foreign tax credit allowable
11 under section 33(a) in computing the regular
12 tax for the taxable year, or
13 "(ii) the tax imposed by subsection (a).
14 "(C) SECTION 904(a) LIMITATION.—For
15 purposes of the determination provided by
16 subparagraph (A), the limitation of section 904(a)
17 shall be an amount equal to the same proportion
18 of the sum of the tax imposed by subsection (a)
19 against which such credit is taken and the regular
20 tax (excluding the tax imposed by section 56)
21 as—
22 "(i) the taxpayer's alternative minimum
23 taxable income from sources without the
24 United States (but not in excess of the tax-

1 payer's entire alternative minimum taxable
2 income), bears to
3 "(ii) his entire alternative minimum tax-
4 able income.
5 For such purpose, the amount of the limitation of
6 section 904(a) shall not exceed the tax imposed by
7 subsection (a).
8 "(D) DEFINITION OF ALTERNATIVE MINI-
9 MUM TAXABLE INCOME FROM SOURCES WITH-
10 OUT THE UNITED STATES.—For purposes of sub-
11 paragraph (C), the term 'alternative minimum tax-
12 able income from sources without the United
13 States' means the items of gross income from
14 sources without the United States adjusted as
15 provided in subparagraph (A), (B), and (C) of sec-
16 tion 55(b)(1) (taking into account in such adjust-
17 ment only items described in such subparagraphs
18 which are properly attributable to items of gross
19 income from sources without the United States).
20 "(E) SPECIAL RULE FOR APPLYING SEC-
21 TION 904(C).—In determining the amount of for-
22 eign taxes paid or accrued during the taxable year
23 which may be deemed to be paid or accrued in a
24 preceding or succeeding taxable year under sec-
25 tion 904(c)—

1 "(i) the limitation of section 904(a) shall
2 be increased by the amount of the limitation
3 determined under subparagraph (C), and
4 "(ii) any increase under subparagraph
5 (B) shall be taken into account."
6 (C) REGULAR TAX DETERMINED WITHOUT
7 REGARD TO FOREIGN TAX CREDIT ALLOWED
8 AGAINST MINIMUM TAX.—Paragraph (2) of sec-
9 tion 55(b) is amended by adding at the end there-
10 of the following new sentence: "For purposes of
11 this paragraph, the amount of the credit allowable
12 under section 33 shall be determined without
13 regard to this section."
14 (D) TREATMENT OF ZERO BRACKET
15 AMOUNT.—Subsection (b) of section 55 (relating
16 to definitions for purposes of alternative minimum
17 tax) is amended by adding at the end thereof the
18 following new paragraph:
19 "(3) TREATMENT OF ZERO BRACKET AMOUNT.—
20 In the case of an individual who does not itemize his
21 itemized deductions, the zero bracket amount shall be
22 treated as a deduction allowed."
23 (E) TREATMENT OF CERTAIN FOREIGN
24 TAXES FOR THE ADJUSTED ITEMIZED DEDUC-
25 TION PREFERENCE.—Paragraphs (1)(A) and

1 (2)(A)(v) of section 57(b) (relating to adjusted
2 itemized deductions) are each amended by insert-
3 ing ", and foreign," after "State and local".
4 (F) ADJUSTED ITEMIZED DEDUCTIONS OF
5 ESTATE OR TRUST.—Subparagraph (A) of section
6 57(b)(2) (defining adjusted itemized deductions of
7 estate or trust) is amended by striking out
8 "clauses (i) through (vi)" and inserting in lieu
9 thereof "clauses (ii) through (vi)".
10 (G) CARRYOVER OF RESIDENTIAL ENERGY
11 CREDIT.—Paragraph (3) of section 55(c) is
12 amended by adding at the end thereof the follow-
13 ing new sentence:
14 "In determining any carryover under subsection
15 44C(b)(6), a rule similar to the rule set forth in sub-
16 paragraph (A) shall be treated as inserted in this para-
17 graph before subparagraph (A), and the applications of
18 subparagraphs (A), (B), and (C) shall be adjusted
19 accordingly."
20 (H) CLERICAL AMENDMENTS.—
21 (i) Subsection (a) of section 55 (relating
22 to alternative minimum tax) is amended by
23 striking out all after paragraph (1) and in-
24 serting in lieu thereof the following:
25 "(2) the regular tax for the taxable year,

1 then there is imposed (in addition to all other taxes imposed
2 by this title) a tax equal to the amount of such excess."
3 (ii) Subparagraph (A) of section 55(c)(3)
4 (relating to carryover and carryback of cer-
5 tain credits) is amended by striking out "sec-
6 tion 53(c)" and inserting in lieu thereof "sec-
7 tion 53(b)".
8 (iii) Paragraph (2) of section 443(d) (re-
9 lating to adjustment in computing minimum
10 tax for tax preferences) is amended by strik-
11 ing out "in the case of a corporation,".
12 (iv) Paragraph (3) of section 453(c) is
13 amended by striking out "section 56" and
14 inserting in lieu thereof "sections 55 and
15 56".
16 (v) Sections 871(b)(1) and 877(b) are
17 each amended by striking out "section 55"
18 and inserting in lieu thereof "55".
19 (vi) The second sentence of section
20 666(c) (relating to pro rata portion of taxes
21 deemed distributed) is amended by inserting
22 "(other than the tax imposed by section 55)"
23 after "equal to the taxes".
24 (vii) Paragraph (4) of section 5(a) is
25 amended by striking out "section 55" and

1 inserting in lieu thereof "sections 55 and
2 56".
3 (viii) Paragraph (2) of section 55(b) is
4 amended by inserting "409(c)," after
5 "408(f),".
6 (5) AMENDMENTS RELATED TO SECTION 441 OF
7 THE ACT.—
8 (A) TRANSITIONAL RULE.—Paragraph (2) of
9 section 441(b) of the Revenue Act of 1978 (relat-
10 ing to transitional rules) is amended to read as
11 follows:
12 "(2) TAXABLE YEARS WHICH STRADDLE NOVEM-
13 BER 1, 1978.—In the case of a taxable year which
14 begins before November 1, 1978, and ends after Octo-
15 ber 31, 1978, the amount taken into account under
16 section 1348(b)(2)(B) of the Internal Revenue Code of
17 1954 by reason of section 57(a)(9) of such Code shall
18 be 50 percent of the lesser of—
19 "(A) the net capital gain for the taxable
20 year, or
21 "(B) the net capital gain taking into account
22 only gain or loss properly taken into account for
23 the portion of the taxable year before November
24 1, 1978."

1 (B) CLERICAL AMENDMENT.—Subsection (a)
2 of section 441 of the Revenue Act of 1978 is
3 amended by striking out "subparagraph (b)" and
4 inserting in lieu thereof "subparagraph (B)".
5 (b) EFFECTIVE DATES.—
6 (1) SPECIAL EFFECTIVE DATE FOR SUBSECTION
7 (a)(2)(B).—The amendments made by subsection
8 (a)(2)(B) shall apply to taxable years beginning in
9 1978.
10 (2) GENERAL EFFECTIVE DATE.—

For general effective date, see section 201.

11 **SEC. 105. AMENDMENTS RELATED TO TITLE V.**
12 (a) GENERAL RULE.—
13 (1) AMENDMENTS RELATED TO SECTION 502 OF
14 THE ACT.—
15 (A) Subsection (g) of section 7463 (relating
16 to small tax case procedures) is hereby repealed.
17 (B) Subsection (c) of section 7456 (relating
18 to commissioners of the Tax Court) is amended by
19 striking out "sections 7428" and inserting in lieu
20 thereof "sections 7428, 7463".
21 (2) AMENDMENT RELATED TO SECTION 504 OF
22 THE ACT.—Paragraph (2) of section 6411(d) (relating
23 to tentative refund of tax under claim of right adjust-
24 ment) is amended to read as follows:

1 "(2) ALLOWANCE OF ADJUSTMENTS.—Within a
2 period of 90 days from the date on which an applica-
3 tion is filed under paragraph (1) or from the date of the
4 overpayment (determined under section 1341(b)(1)),
5 whichever is later, the Secretary shall—
6 "(A) review the application,
7 "(B) determine the amount of the overpay-
8 ment, and
9 "(C) apply, credit, or refund such overpay-
10 ment,
11 in a manner similar to the manner provided in subsec-
12 tion (b)."
13 (3) AMENDMENTS RELATED TO SECTION 511 OF
14 THE ACT.—
15 (A) AGGREGATE ADJUSTED CONSIDERATION
16 MUST BE LESS THAN VALUE.—Paragraph (2) of
17 section 2040(c) (relating to limitations) is amended
18 by adding at the end thereof the following new
19 subparagraph:
20 "(C) AGGREGATE ADJUSTED CONSIDERA-
21 TION MUST BE LESS THAN VALUE.—Paragraph
22 (1) shall not apply if the sum of—
23 "(i) the adjusted consideration furnished
24 by the decedent, and

1 "(ii) the adjusted consideration furnished
2 by the decedent's spouse,
3 equals or exceeds the value of the interest."
4 (B) CLERICAL AMENDMENT.—Paragraph (1)
5 of section 2040(c) is amended by striking out
6 "subsections (a)" and inserting in lieu thereof
7 "subsection (a)".
8 (4) AMENDMENTS RELATED TO SECTION 514 OF
9 THE ACT.—The first sentence of paragraph (3) of sec-
10 tion 2055(e) is amended—
11 (A) by striking out "subparagraph (a) or (B)"
12 and inserting in lieu thereof "subparagraph (A) or
13 (B)", and
14 (B) by striking out "so that interest" and in-
15 serting in lieu thereof "so that the interest".
16 (5) AMENDMENTS RELATED TO SECTION 515 OF
17 THE ACT.—
18 (A) AMENDMENT OF SECTION 1040 OF THE
19 CODE.—Section 1040 (relating to use of certain
20 appreciated carryover basis property to satisfy pe-
21 cuniary bequest) is amended by adding at the end
22 thereof the following new subsection:
23 "(d) APPLICATION TO SECTION 2032A PROPERTY.—
24 For purposes of this section, references to carryover basis

1 property shall be treated as including a reference to property
2 the valuation of which is determined under section 2032A."
3 (B) PERIOD FOR WHICH SECTION 1040 AP-
4 PLIES.—Notwithstanding section 515 of the Rev-
5 enue Act of 1978, section 1040 of the Internal
6 Revenue Code of 1954 (as amended by subpara-
7 graph (A)) shall apply with respect to the estates
8 of decedents dying after December 31, 1976.
9 (6) AMENDMENTS RELATED TO SECTION 531 OF
10 THE ACT.—Paragraph (6) of section 216(b) (relating to
11 deduction of taxes, interest, and business depreciation
12 by cooperative housing corporation tenant-stockholder)
13 is amended by redesignating subparagraphs (B) and (C)
14 as subparagraphs (C) and (D), respectively, and by
15 striking out subparagraph (A) and inserting in lieu
16 thereof the following new subparagraphs:
17 "(A) IN GENERAL.—If the original seller ac-
18 quires any stock of the corporation from the cor-
19 poration or by foreclosure, the original seller shall
20 be treated as a tenant-stockholder for a period not
21 to exceed 3 years from the date of the acquisition
22 of such stock.
23 "(B) STOCK ACQUISITION MUST TAKE
24 PLACE NOT LATER THAN 1 YEAR AFTER TRANS-
25 FER OF DWELLING UNITS.—Except in the case of

1 an acquisition of stock of a corporation by foreclo-
2 sure, subparagraph (A) shall apply only if the ac-
3 quisition of stock occurs not later than 1 year
4 after the date on which the apartments or houses
5 (or leaseholds therein) are transferred by the origi-
6 nal seller to the corporation. For purposes of this
7 subparagraph and subparagraph (A), the term 'by
8 foreclosure' means by foreclosure (or by instru-
9 ment in lieu of foreclosure) of any purchase-
10 money security interest in the stock held by the
11 original seller."
12 (7) AMENDMENTS RELATED TO SECTION 543 OF
13 THE ACT.—
14 (A) Section 126 (relating to certain cost-
15 sharing payments) is amended by striking out sub-
16 sections (b) and (c) and inserting in lieu thereof
17 the following:
18 "(b) EXCLUDABLE PORTION.—For purposes of this
19 section—
20 "(1) IN GENERAL.—The term 'excludable portion'
21 means that portion (or all) of a payment made to any
22 person under any program described in subsection (a)
23 which—
24 "(A) is determined by the Secretary of Agri-
25 culture to be made primarily for the purpose of

1 conserving soil and water resources, protecting or
2 restoring the environment, improving forests, or
3 providing a habitat for wildlife, and
4 "(B) is determined by the Secretary of the
5 Treasury or his delegate as not increasing sub-
6 stantially the annual income derived from the
7 property.
8 "(2) PAYMENTS NOT CHARGEABLE TO CAPITAL
9 ACCOUNT.—The term 'excludable portion' does not in-
10 clude that portion of any payment which is properly
11 associated with an amount which is allowable as a de-
12 duction for the taxable year in which such amount is
13 paid or incurred.
14 "(c) ELECTION FOR SECTION NOT TO APPLY.—
15 "(1) IN GENERAL.—The taxpayer may elect not
16 to have this section (and section 1255) apply to any
17 excludable portion (or portion thereof).
18 "(2) MANNER AND TIME FOR MAKING ELEC-
19 TION.—Any election under paragraph (1) shall be
20 made in the manner prescribed by the Secretary by
21 regulations and shall be made not later than the due
22 date prescribed by law (including extensions) for filing
23 the return of tax under this chapter for the taxable
24 year in which the payment was received or accrued.

1 "(d) DENIAL OF DOUBLE BENEFITS.—No deduction or
2 credit shall be allowed with respect to any expenditure which
3 is properly associated with any amount excluded from gross
4 income under subsection (a).

5 "(e) BASIS OF PROPERTY NOT INCREASED BY
6 REASON OF EXCLUDABLE PAYMENTS.—Notwithstanding
7 any provision of section 1016 to the contrary, no adjustment
8 to basis shall be made with respect to property acquired or
9 improved through the use of any payment, to the extent that
10 such adjustment would reflect any amount which is excluded
11 from gross income under subsection (a)."

12 (B) Paragraph (1) of section 1255(a) is
13 amended by striking out all after subparagraph
14 (B)(i) and inserting in lieu thereof the following:

15 "(ii) the adjusted basis of such property,
16 shall be treated as ordinary income. Such gain shall be
17 recognized notwithstanding any other provision of this
18 subtitle, except that this section shall not apply to the
19 extent such gain is recognized as ordinary income
20 under any other provision of this part."

21 (C) Subsection (a)(9) of section 126 (relating
22 to certain cost-sharing payments) is amended by
23 inserting "or his delegate" after "Secretary of the
24 Treasury".

1 (D) Paragraph (2) of section 1255(b) (relating
2 to special rules applicable to gain from disposition
3 of section 126 property) is amended by striking
4 out "(2)" and inserting in lieu thereof "(2) for
5 purposes of sections 163(d), 170(e), 341(e)(12),
6 453(d)(4)(B), and 751(c),".
7 (b) EFFECTIVE DATES.—
8 (1) SPECIAL EFFECTIVE DATE FOR SUBSECTION
9 (a)(1).—The amendments made by subsection (a)(1)
10 shall take effect on the date of the enactment of this
11 Act.
12 (2) GENERAL EFFECTIVE DATE.—

For general effective date, see section 201.

13 **SEC. 106. AMENDMENTS RELATED TO TITLE VI.**

14 (a) IN GENERAL.—
15 (1) Paragraph (1) of section 172(b) (relating to net
16 operating loss carrybacks and carryovers) is amended
17 by redesignating the subparagraph (H) added by sec-
18 tion 601(b)(1) of the Revenue Act of 1978 as subpara-
19 graph (I).
20 (2) Subsection (a) of section 1016 (relating to ad-
21 justments of basis) is amended by redesignating the
22 paragraph (21) added by section 601(b)(3) of the Reve-
23 nue Act of 1978 as paragraph (22).

1 (3) Paragraph (3) of section 601(b) of the Revenue
2 Act of 1978 is amended by striking out "by redesig-
3 nating paragraph (23) as (22) and by inserting after
4 paragraph (20)" and inserting in lieu thereof "by in-
5 serting before paragraph (23)".
6 (4) Subsection (a) of section 1391 (defining gen-
7 eral stock ownership corporation) is amended—
8 (A) by striking out ", and" at the end of
9 paragraph (1) and inserting in lieu thereof a semi-
10 colon,
11 (B) by inserting "or" at the end of paragraph
12 (4)(D)(ii),
13 (C) by inserting "and" at the end of para-
14 graph (4)(D)(iii), and
15 (D) by inserting "and" at the end of para-
16 graph (4)(E).
17 (5) Subsection (c) of section 1392 is amended by
18 striking out "WHERE" in the subsection heading and
19 inserting in lieu thereof "WHEN".
20 (6) Subparagraph (A) of section 172(b)(1) is
21 amended by striking out "and (H)" and inserting in
22 lieu thereof ", (H), and (I)".
23 (7) Subparagraph (B) of section 172(b)(1) is
24 amended by striking out "and (G)" and inserting in
25 lieu thereof "(G), and (I)".

1 (b) EFFECTIVE DATE.—

For general effective date, see section 201.

2 **SEC. 107. AMENDMENTS RELATED TO TITLE VII.**

3 (a) IN GENERAL.—

4 (1) AMENDMENTS RELATED TO SECTION 701 OF
5 THE ACT.—

6 (A) COMPUTATION OF ADJUSTED ITEMIZED
7 DEDUCTIONS IN CASE OF ESTATES AND
8 TRUSTS.—Subparagraph (C) of section 57(b)(2)
9 (relating to special rules for estates and trusts) is
10 amended by striking out "section 170(c)(2)(B)"
11 each place it appears and inserting in lieu thereof
12 "section 170(c) (determined without regard to sec-
13 tion 170(c)(2)(A))".

14 (B) EFFECTIVE DATE FOR PROVISION RE-
15 LATING TO FOREIGN TAXES ATTRIBUTABLE TO
16 SECTION 911 EXCLUSION.—Subparagraph (B) of
17 section 701(u)(10) of the Revenue Act of 1978
18 (relating to effective date) is amended to read as
19 follows:

20 "(B) EFFECTIVE DATE.—The amendment
21 made by subparagraph (A) shall apply to taxable
22 years beginning in calendar year 1978 but only in
23 the case of taxpayers who make an election under

1 section 209(c) of the Foreign Earned Income Act
2 of 1978."
3 (C) CLERICAL AMENDMENTS.—
4 (i) Paragraph (3) of section 701(a) of the
5 Revenue Act of 1978 is amended by striking
6 out "Subsection (c)" and inserting in lieu
7 thereof "Subsection (e)".
8 (ii) Subparagraph (C) of section 191(f)(2)
9 is amended by striking out "the date of" and
10 inserting in lieu thereof "the date".
11 (2) AMENDMENTS RELATED TO SECTION 702 OF
12 THE ACT.—
13 (A) Paragraph (3) of section 1014(a) is
14 amended by striking out "section 2032.1" and in-
15 serting in lieu thereof "section 2032A".
16 (B) Subparagraph (B) of section 2613(e)(2) is
17 amended by striking out clause (vi), by inserting
18 "or" at the end of clause (v), and by redesignat-
19 ing clause (vii) as clause (vi).
20 (C) Paragraph (3) of section 702(r) of the
21 Revenue Act of 1978 is hereby repealed.
22 (D) The section 6698 which relates to failure
23 to file information with respect to carryover basis
24 property is redesignated as section 6698A.

1 (E) The table of sections for subchapter B of
2 chapter 68 is amended by striking out

"Sec. 6698. Failure to file information with respect to carryover basis property."

3 and inserting in lieu thereof the following:

"Sec. 6698A. Failure to file information with respect to carryover basis property.",

4 (F)(i) If the executor elects the benefits of
5 this subparagraph with respect to any estate, sec-
6 tion 2035(b) of the Internal Revenue Code of
7 1954 (relating to adjustments for gifts made
8 within 3 years of decedent's death) shall be ap-
9 plied with respect to transfers made by the dece-
10 dent during 1977 as if paragraph (2) of such sec-
11 tion 2035(b) read as follows:
12 "(2) to any gift to a donee made during 1977 to
13 the extent of the amount of such gift which was ex-
14 cludable in computing taxable gifts by reason of section
15 2503(b) (relating to $3,000 annual exclusion for pur-
16 poses of the gift tax) determined without regard to sec-
17 tion 2513(a)."
18 (ii) The election under clause (i) with respect
19 to any estate shall be made on or before the later
20 of—
21 (I) the due date for filing the estate tax
22 return, or

1 (II) the day which is 120 days after the
2 date of the enactment of this Act.
3 (3) AMENDMENTS RELATED TO SECTION 703 OF
4 THE ACT.—
5 (A) The first sentence of paragraph (8) of
6 section 46(f) is amended by striking out "subsec-
7 tion (a)(7)(D)" and inserting in lieu thereof "sub-
8 section (a)(7)(C)".
9 (B) Subsection (e) of section 703 of the Rev-
10 enue Act of 1978 is hereby repealed.
11 (C) Paragraph (1) of section 703(q) of the
12 Revenue Act of 1978 is amended by striking out
13 "section 103(d)" and inserting in lieu thereof
14 "section 103(c)".
15 (b) EFFECTIVE DATE.—

For general effective date, see section 201.

16 **SEC. 108. AMENDMENTS RELATED TO CERTAIN OTHER ACTS**
17 **ENACTED DURING 1978.**
18 (a) FOREIGN EARNED INCOME ACT OF 1978.—
19 (1) IN GENERAL.—
20 (A) TAX TABLES TO APPLY TO INDIVID-
21 UALS CLAIMING SECTION 911 EXCLUSION.—Sec-
22 tion 202 of the Foreign Earned Income Act of
23 1978 is amended by redesignating subsection (f)

1 as subsection (g) and by inserting after subsection
2 (e) the following new subsection:
3 "(f) TAX TABLES TO APPLY TO INDIVIDUALS CLAIM-
4 ING SECTION 911 EXCLUSION.—Paragraph (1) of section
5 3(b) (relating to tax tables not to apply to certain individuals)
6 is amended by striking out subparagraph (A)."
7 (B) DETERMINATION OF HOUSING DEDUC-
8 TION.—
9 (i) Clause (i) of section 913(e)(3)(A) is
10 amended by striking out "earned income"
11 each place it appears and inserting in lieu
12 thereof "housing income".
13 (ii) Subsection (e) of section 913 is
14 amended by adding at the end thereof the
15 following new paragraphs:
16 "(6) HOUSING INCOME.—For purposes of this
17 subsection, the term 'housing income' has the meaning
18 given to the term 'earned income' by section 911(b)
19 (determined with the rule set forth in paragraph (3) of
20 section 911(c)).
21 "(7) RECAPTURE OF EXCESS HOUSING DEDUC-
22 TIONS ATTRIBUTABLE TO TREATMENT OF AFTER-
23 RECEIVED COMPENSATION.—
24 "(A) IN GENERAL.—There shall be included
25 in the gross income of the individual for the tax-

1 able year in which any after-received compensa-
2 tion is received an amount equal to any excess
3 housing deduction determined for such year.
4 "(B) EXCESS HOUSING DEDUCTION.—For
5 purposes of subparagraph (A), the excess housing
6 deduction determined for any taxable year is the
7 excess (if any) of—
8 "(i) the aggregate amount which has
9 been allowed as a housing deduction (for
10 such taxable year and all prior taxable
11 years), over
12 "(ii) the aggregate amount which would
13 have been allowable as a housing deduction
14 (for such taxable year and all prior taxable
15 years for which a housing deduction has been
16 allowed), by taking after-received compensa-
17 tion into account under this subsection as if
18 it had been received in the taxable year in
19 which the services were performed.
20 In applying the preceding sentence to any taxable
21 year, proper adjustment shall be made for the
22 effect of applying such sentence for purposes of all
23 prior taxable years.
24 "(C) TREATMENT OF AMOUNT INCLUDED IN
25 INCOME.—Any amount included in gross income

1 under subparagraph (A) shall not be treated as
2 income for purposes of applying subsection (c) of
3 this section.
4 "(D) DEFINITIONS.—For purposes of this
5 paragraph—
6 "(i) HOUSING DEDUCTION.—The term
7 'housing deduction' means that portion of the
8 deduction allowable under subsection (a) for
9 any taxable year which is attributable to
10 qualified housing expenses. For such pur-
11 pose, qualified housing expenses shall be
12 taken into account after all other amounts
13 described in subsection (b).
14 "(ii) AFTER-RECEIVED COMPENSA-
15 TION.—The term 'after-received compensa-
16 tion' means compensation received by an in-
17 dividual in a taxable year which is attributa-
18 ble to services performed by such individual
19 in the third preceding, second preceding, or
20 first preceding taxable year."
21 (C) CLERICAL AMENDMENT.—Paragraph (2)
22 of section 911(a) (relating to income earned by in-
23 dividuals in certain camps) is amended by striking
24 out "qualified foreign" and inserting in lieu there-
25 of "a foreign country or".

1 (D) AMENDMENT OF LAST SENTENCE OF
2 SECTION 911(a).—The last sentence of section
3 911(a) (relating to income earned by individuals in
4 certain camps) is amended—
5 (i) by inserting "any deduction," after
6 "his gross income", and
7 (ii) by striking out "deductions allowed
8 by sections 217" and inserting in lieu thereof
9 "deduction allowed by section 217".
10 (E) AMENDMENT OF SECTION 3(b).—Para-
11 graph (1) of section 3(b) is amended by redesig-
12 nating subparagraphs (B) and (C) as subpara-
13 graphs (A) and (B), respectively.
14 (F) QUALIFIED HOME LEAVE TRAVEL EX-
15 PENSES.—
16 (i) Subsection (g) of section 913 (relat-
17 ing to qualified home leave travel expenses)
18 is amended to read as follows:
19 "(g) QUALIFIED HOME LEAVE TRAVEL EXPENSES.—
20 "(1) IN GENERAL.—For purposes of this section,
21 the term 'qualified home leave travel expenses' means
22 the reasonable amounts paid or incurred by or on
23 behalf of an individual for the transportation of such in-
24 dividual, his spouse, and each dependent—

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1 "(A) from a point of outside the United
2 States to the individual's principal domestic resi-
3 dence, and
4 "(B) from the individual's principal domestic
5 residence to a point outside the United States.
6 "(2) LIMITATION TO COST BETWEEN TAX HOME
7 AND PLACE OF RESIDENCE.—The amount taken into
8 account under subparagraph (A) or (B) of paragraph (1)
9 with respect to any transportation shall not exceed the
10 reasonable amount for transportation between the loca-
11 tion of the individual's tax home outside the United
12 States and the individual's principal domestic resi-
13 dence.
14 "(3) SUBSTITUTION OF NEAREST PORT OF
15 ENTRY IN CERTAIN CASES.—With respect to any
16 person whose travel in the United States is not travel
17 to and from the individual's principal domestic resi-
18 dence, paragraphs (1) and (2) shall be applied by sub-
19 stituting the nearest port of entry in the United States
20 for the individual's principal domestic residence.
21 "(4) NEAREST PORT OF ENTRY.—For purposes
22 of paragraph (3), the nearest port of entry in the
23 United States shall not include a nearest port of entry
24 located in Alaska or Hawaii unless the individual
25 elects to have such port of entry taken into account.

1 "(5) PRINCIPAL DOMESTIC RESIDENCE DE-
2 FINED.—For purposes of this subsection, an individ-
3 ual's principal domestic residence is the location of
4 such individual's present (or, if none, most recent) prin-
5 cipal residence in the United States.
6 "(6) 1 ROUND TRIP PER 12-MONTH PERIOD
7 ABROAD.—Amounts may be taken into account under
8 paragraph (4) of subsection (b) only with respect to 1
9 trip to the United States, and 1 trip from the United
10 States, per person for each continuous period of 12
11 months for which the individual's tax home is in a for-
12 eign country."
13 (ii) Clause (ii) of section 913(i)(l)(C) (re-
14 lating to qualified second household) is
15 amended by striking out ", and paragraph (1)
16 of subsection (g)," and inserting in lieu
17 thereof ", and subsection (g),".
18 (G) AMENDMENT OF SECTION 119.—Sub-
19 section (a) of section 119 (as in effect on the day
20 before the date of the enactment of the Foreign
21 Earned Income Act of 1978) is amended by strik-
22 ing out "(a) GENERAL RULE.—".
23 (2) EFFECTIVE DATES.—
24 (A) IN GENERAL.—Except as provided in
25 subparagraph (B), the amendments made by para-

1 graph (1) shall take effect as if included in the
2 Foreign Earned Income Act of 1978.
3 (B) PARAGRAPH (1)(E).—The amendment
4 made by paragraph (1)(E) shall apply to taxable
5 years beginning after December 31, 1978.
6 (b) AMENDMENTS RELATED TO THE BLACK LUNG
7 BENEFITS REVENUE ACT.—
8 (1) CORRECTION OF PROVISIONS RELATED TO
9 TAX COURT JURISDICTION.—
10 (A) Subsection (g) of section 6503 is
11 amended—
12 (i) by striking out "4971, 4975, 4985,
13 or 4986" and inserting in lieu thereof
14 "4951, 4952, 4971, or 4975", and
15 (ii) by striking out "4971(c)(3),
16 4975(f)(6), 4985(e)(4), or 4986(e)(2)" and in-
17 serting in lieu thereof "4951(e)(4),
18 4952(e)(2), 4971(c)(3), or 4975(f)(6)".
19 (B) Subsection (f) of section 6511 is
20 amended—
21 (i) by inserting "or section 4975" after
22 "chapter 42", and
23 (ii) by striking out "CHAPTER 42" in
24 the subsection heading and inserting in lieu

1 thereof "CHAPTER 42 AND CERTAIN CHAP-
2 TER 43".
3 (C) Section 6862 is amended by striking out
4 "certain excise taxes" and inserting in lieu there-
5 of "the taxes imposed by chapters 41, 42, 43,
6 and 44".
7 (D) Subsection (g) of section 7422 is
8 amended by striking out "4944, 4945" each place
9 it appears and inserting in lieu thereof "4944,
10 4945, 4951, 4952".
11 (E) Paragraph (1) of section 7422(g) is
12 amended by striking out "section 4945(a) (relating
13 to initial taxes on taxable expenditures)" and in-
14 serting in lieu thereof "section 4945(a) (relating to
15 initial taxes on taxable expenditures), section
16 4951(a) (relating to initial taxes on self-dealing),
17 4952(a) (relating to initial taxes on taxable
18 expenditures)".
19 (F) Subsection (g) of section 7422 is
20 amended by striking out "section 4945(b) (relating
21 to additional taxes on taxable expenditures)" and
22 inserting in lieu thereof "section 4945(b) (relating
23 to additional taxes on taxable expenditures), sec-
24 tion 4951(b) (relating to additional taxes on self-

1 dealing), 4952(b) (relating to additional taxes on
2 taxable expenditures)".
3 (2) CORRECTION OF REFERENCES TO 1969
4 ACT.—
5 (A) Subsections (b), (c)(1), and (d) of section
6 3 of the Black Lung Benefits Revenue Act of
7 1977 are each amended by striking out "Federal
8 Coal Mine Health and Safety Act of 1969" each
9 place it appears and inserting in lieu thereof
10 "Federal Mine Safety and Health Act of 1977".
11 (B) Sections 501(c)(21) and 192(e) are each
12 amended by striking out "Federal Coal Mine
13 Health and Safety Act of 1969" and inserting in
14 lieu thereof "Federal Mine Safety and Health Act
15 of 1977".
16 (3) CLERICAL AMENDMENT.—Paragraph (1) of
17 section 3(c) of the Black Lung Benefits Revenue Act of
18 1977 is amended by striking out "subsection (a)(4)"
19 and inserting in lieu thereof "subsection (a)(5)".
20 (4) EFFECTIVE DATE.—Any amendment made by
21 this subsection shall take effect as if included in the
22 provision of the Black Lung Benefits Revenue Act of
23 1977 to which such amendment relates.
24 (c) AMENDMENTS RELATED TO ENERGY TAX ACT OF
25 1978.—

1 (1) REPAYMENT OF TAX ON GASOLINE USED IN
2 COMMERCIAL FISHERIES.—Subparagraph (B) of sec-
3 tion 6421(d)(2) (defining qualified business use) is
4 amended by adding at the end thereof the following
5 new sentence: "The preceding sentence shall not apply
6 to use in a vessel employed in the fisheries or in the
7 whaling business."
8 (2) AMENDMENTS RELATED TO TREATMENT OF
9 GASOLINE MIXED WITH ALCOHOL.—
10 (A) Subparagraph (H) of section 6416(b)(2)
11 (relating to specified uses and resales) is amended
12 by inserting "or in a mixture described in section
13 4081(c)" after "section 4041".
14 (B) Paragraph (2) of section 4081(c) (relating
15 to later separation of gasoline) is amended by in-
16 serting "(or with respect to which credit or refund
17 was allowed or made by reason of section
18 6416(b)(2)(H))" after "this subsection".
19 (3) TIRES USED IN MANUFACTURE OF BUSES.—
20 (A) Subparagraph (C) of section 6416(b)(3)
21 (relating to tax-paid articles used for further man-
22 ufacture, etc.) is amended by striking out "such
23 other article is" and all that follows and inserting
24 in lieu thereof the following:
25 "such other article is—

1 "(i) an automobile bus chassis or an
2 automobile bus body, or
3 "(ii) by any person exported, sold to a
4 State or local government for the exclusive
5 use of a State or local government, sold to a
6 nonprofit educational organization for its ex-
7 clusive use, or used or sold for use as sup-
8 plies for vessels or aircraft;".
9 (B) Subparagraph (B) of section 6416(b)(4)
10 (relating to tires and inner tubes) is amended to
11 read as follows:
12 "(B) such other article is—
13 "(i) an automobile bus chassis or an
14 automobile bus body, or
15 "(ii) by any person exported, sold to a
16 State or local government for the exclusive
17 use of a State or local government, sold to a
18 nonprofit educational organization for its ex-
19 clusive use, or used or sold for use as sup-
20 plies for vessels or aircraft,".
21 (C) Subsection (e) of section 4071 (relating
22 to tires on imported articles) is amended by strik-
23 ing out "under section 4061" and inserting in lieu
24 thereof "under section 4061 or if such article is

1 an automobile bus chassis or an automobile bus
2 body";
3 (4) REFUND OF TAX ON LUBRICATING OIL USED
4 IN PRODUCING REREFINED OIL.—Paragraph (2) of
5 section 6416(b) (relating to credit or refund for certain
6 uses) is amended by striking out "or" at the end of
7 subparagraph (L), by striking out the period at the end
8 of subparagraph (M) and inserting in lieu thereof ";
9 or", and by inserting after subparagraph (M) the
10 following:
11 "(N) in the case of lubricating oil taxable
12 under section 4091 which is contained in a mix-
13 ture which is rerefined oil (as defined in section
14 4093(b)(3)), used or sold.
15 The amount of the credit or refund under subparagraph
16 (N) with respect to any lubricating oil shall be the
17 amount which would be exempt from tax under section
18 4093."
19 (5) CREDIT OR REFUND OF TAX ON TRUCK
20 CHASSIS OR BODY USED IN THE MANUFACTURE OF A
21 BUS.—Subparagraph (A) of section 6416(b)(3) (relating
22 to tax-paid articles used for further manufacture, etc.)
23 is amended by striking out "component part of," and
24 all that follows and inserting in lieu thereof the follow-
25 ing:

1 "component part of—
2 "(i) another article taxable under chap-
3 ter 32, or
4 "(ii) an automobile bus chassis or an
5 automobile bus body,
6 manufactured or produced by him;".
7 (6) CLERICAL AMENDMENT.—The last sentence
8 of section 48(a)(10)(B) is amended by striking out "51"
9 and inserting in lieu thereof "5".
10 (7) EFFECTIVE DATE.—Any amendment made by
11 this subsection shall take effect as if included in the
12 provision of the Energy Tax Act of 1978 to which
13 such amendment relates.

14 TITLE II—GENERAL EFFECTIVE 15 DATE

16 **SEC. 201. GENERAL EFFECTIVE DATE.**

17 Except as otherwise provided in title I, any amendment
18 made by title I shall take effect as if it had been included in
19 the provision of the Revenue Act of 1978 to which such
20 amendment relates.

Passed the House of Representatives July 16, 1979.

Attest: EDMUND L. HENSHAW, JR.,

Clerk.

DESCRIPTION OF S. 873 AND S. 1549

SCHEDULED FOR A HEARING
BEFORE THE
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT GENERALLY
OF THE
SENATE COMMITTEE ON FINANCE
ON
NOVEMBER 7, 1979

PREPARED BY THE STAFF OF THE
JOINT COMMITTEE ON TAXATION

NOVEMBER 6, 1979

JCX-2-79

I. SUMMARY

1. S. 873--Senators Ribicoff, Bentsen, Tower, Hayakawa, Church, and Javits

Waiver of Time Limits in Foreign Residence or Presence Requirement for Americans Working Abroad

The bill would permit the waiver of the minimum time limits in the foreign residence or presence eligibility requirements for Americans working abroad to obtain the benefits of the deduction for excess foreign living costs or the exclusion for foreign earned income. The waiver generally would be available to Americans working abroad who could reasonably have been expected to meet those eligibility requirements, but who left the foreign country under conditions of war, civil unrest or similar conditions which precluded the normal conduct of business.

2. S. 1549 -- Senators Boren, Bellmon, Nelson, and Percy

Change of Time for Paying Excise Tax on Fishing Equipment

Under present law, a 10-percent excise tax is imposed upon the sale of fishing rods, creels, reels, and artificial lures, baits, and flies by the manufacturer, producer, or importer thereof. This tax generally is payable relatively soon after such fishing equipment is sold.

The bill would provide that the excise tax on fishing equipment sold during quarters ending on December 31, March 31, and June 30, would be payable, respectively, on March 31, June 30, and September 24. For the quarter ending September 30, the tax would be due by the date specified by Treasury regulations.

II. DESCRIPTION OF BILLS

1. S. 873--Senators Ribicoff, Bentsen, Tower, Hayakawa, Church, and Javits

Waiver of Time Limits in Foreign Residence or Presence Requirement for Americans Working Abroad

Present law

Prior to enactment of the Foreign Earned Income Act of 1978, an American who was present in a foreign country or countries for at least 510 full days during any period of 18 consecutive months, or who was a bona fide resident of a foreign country or countries for an uninterrupted period which included an entire taxable year, was entitled to exclude up to a flat amount (generally $20,000) per year of his foreign earned income (sec. 911).

The 1978 Act retained these eligibility requirements but changed the special provisions for Americans working abroad. Generally, qualifying individuals are allowed a deduction for their excess foreign costs of living. The new excess living cost deduction (new sec. 913) consists of separate elements for the general cost of living, housing, education, and home leave costs. In addition, taxpayers living and working in certain hardship areas are allowed a special $5,000 deduction in order to compensate them for the hardships involved and to encourage U.S. citizens to accept employment in these areas. As an exception to these new rules, the Act permits employees who reside in camps in hardship areas to elect to claim a $20,000 earned income exclusion (under sec. 911) in lieu of the new excess living cost and hardship area deductions. As noted above, the foreign presence or residence criteria of prior law continue to determine whether or not Americans working abroad qualify for the special deduction or exclusion.

If a taxpayer working abroad is "temporarily" away from home in pursuit of a trade or business, the taxpayer may generally deduct traveling expenses (including amounts spent for meals and lodging) for himself but generally not for family members who accompany him. The taxpayer's "home" for this purpose is generally his principal place of employment. While a determination of whether the taxpayer is "temporarily" away from home depends on all the facts and circumstances, the Internal Revenue Service often holds that the taxpayer is "temporarily" away from home if his employment is not anticipated to, and does not actually, last more than a year. Otherwise, the Service ordinarily views the taxpayer as not being temporarily away from home and not entitled to these deductions.[1] A number of items

[1] Rev. Rul. 60-189, 1960-1 C.B. 60.

in the deduction for excess foreign living costs are measured with reference to the location of the individual's tax home.

Issue

The issue is whether, in a case where an individual goes abroad with the expectation of meeting the foreign residence or presence requirements, but fails to meet those requirements because of extraordinary circumstances beyond his control, relief should be afforded from the time limitations.

Because of the recent civil unrest in Iran, a number of Americans who were working there with the expectation of meeting the foreign residence or presence requirements returned to the United States prior to the time that those requirements actually were met.

Explanation of the bill

The bill would provide that, under certain circumstances, the time limits of the foreign residence or presence eligibility requirements for the deduction for excess foreign living costs or the exclusion for foreign earned income may be waived. Three conditions must be met for the waiver to apply. First, the individual must actually have been a *bona fide* resident of, or present in, a foreign country. Second, he must leave the foreign country during a period with respect to which the Treasury Department determines, after consultation with the State Department, that individuals were required to leave the foreign country because of war, civil unrest, or similar adverse conditions in the foreign country which precluded the normal conduct of business by those individuals. (These determinations may be made for any period after September 1, 1978.) Third, the individual must establish to the satisfaction of the Treasury that he could reasonably have been expected to meet the time limitation requirements. If these criteria are met, the taxpayer would be treated as having met the foreign residence or presence requirements with respect to the period during which he was a *bona fide* resident or was present in the foreign country even though the relevant time limitation under existing law had not been met. Moreover, an individual who can establish that he could reasonably have been expected to meet the time limitation requirements would ordinarily be able to establish that his tax home was abroad for the purposes of the deduction for excess foreign living costs.

Effective date

The provisions of the bill would apply to taxable years beginning after December 31, 1976, but only with respect to periods during which an individual was a bona fide resident of or present in a foreign country and did not meet the time limitation requirements of the foreign residence or presence tests with respect to those periods because he left the foreign country after September 1, 1978.

Revenue effect

This bill would have no effect upon budget receipts. It forgives an unanticipated one-time tax increase of $10 million in fiscal 1980.

2. S. 1549 -- Senators Boren, Bellmon, Nelson, and Percy

Change of Time for Paying Excise Tax on Fishing Equipment

Present law

Under present law (Code sec. 4161(a)), there is imposed upon the sale of fishing rods, creels, reels, and artificial lures, baits, and flies (including parts or accessories of such articles sold on or in connection therewith, or with the sale thereof) by the manufacturer, producer, or importer a tax equivalent to 10 percent of the price for which so sold.

Treasury Department regulations prescribing the time for making deposits of manufacturers excise taxes are contained in Treas. Reg. sec. 48.6302(c)-1. If an individual is liable in any month for more than $100 of taxes reportable on Form 720 (Quarterly Excise Return) and he or she is not required to make semimonthly deposits, the individual must deposit the amount on or before the last day of the next month at an authorized depository or at the Federal Reserve Bank serving the area in which the individual is located. If an individual had more than $2,000 in excise tax liability for any month of a preceding calendar quarter, he or she must deposit such taxes for the following quarter (regardless of amount) on a semimonthly basis. The taxes must be deposited by the ninth day following the semimonthly period for which they are reported. In addition, if the semimonthly period is in either of the first two months of the quarter, any underpayment of excise taxes for a month must be deposited by the ninth day of the second month following such month. Underpayments in the third month of the quarter must be deposited by the end of the following month.

No special rules are provided to defer payments of the excise tax with respect to sales of taxable articles on credit except in the case of certain installment sales.

Issue

Retail sale of sport fishing equipment is seasonal in nature. However, manufacturers of such equipment produce throughout the year in order to make efficient use of capital and labor. To avoid inventory storage costs otherwise resulting from year-round production, manufacturers encourage wholesalers and retailers to make early purchases of fishing equipment stock by offering extended credit terms. The manufacturers excise tax on fishing equipment is payable relatively soon after the

fishing equipment is sold by the manufacturer, regardless of the fact that the deferred credit terms may result in sales' proceeds not being collected for several months.

The issue is whether the payment of excise taxes imposed upon the sale of fishing equipment should be postponed in order to match more closely the collection of sales' proceeds by the manufacturer, producer, or importer.

Explanation of the bill

The bill provides that the manufacturers excise tax imposed on the sale of fishing equipment would be payable in accordance with the following schedule:

For articles sold during the quarter ending:	Payment of the tax is due by:
December 31	March 31
March 31	June 30
June 30	September 24
September 30	According to Treasury Regulations

In the case of sales of fishing equipment made during the first two quarters of the Federal fiscal year, the bill extends the due date for payment for up to 5 months and 1 week beyond that applicable under present law. In the case of sales made during the third such quarter (ending June 30), the extension is not as long (September 24), in order to insure that all payments for sales made through June 30 are included in Federal Government receipts for the fiscal year, which ends on September 30.

In the case of sales made during the fourth quarter of the fiscal year, the bill does not require any change from the payment schedule presently in effect under Treasury regulations (Treas. Reg. sec. 48. 6302(c)-1). However, the bill does not preclude the Secretary of the Treasury from changing such regulations , to the extent the Secretary from time to time may deem appropriate, with respect to the due date for payment of excise taxes incurred on sales of fishing equipment made during the quarter ending September 30.

Effective date

The bill would apply to excise taxes payable on fishing equipment sold on or after October 1, 1979.

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Revenue effect

This provision will not affect the aggregate fiscal year receipts of the manufacturers excise tax on fishing equipment.

Prior Congressional action

The provisions of S. 1549 are included as section 7 of H.R. 5505 as passed the House, except that the effective date of the House provision is for excise taxes payable on fishing equipment sold on or after the first day of the first calendar quarter beginning after the date of enactment.

DESCRIPTION OF H.R. 2797: TECHNICAL CORRECTIONS ACT OF 1979

AS PASSED THE HOUSE

I. INTRODUCTION

This pamphlet describes the technical revisions to the Revenue Act of 1978 (Public Law 95-600), the Foreign Earned Income Act of 1978 (Public Law 95-615), the Black Lung Benefits Revenue Act of 1977 (Public Law 95-488), and the Energy Tax Act of 1978 (Public Law 95-618) contained in the Technical Corrections Act of 1979 as it passed the House of Representatives (H.R. 2797).

The technical amendments made by the Technical Corrections Act of 1979 are intended to clarify and conform various provisions adopted by the acts listed above. The bill is based on a review by the staff of the Joint Committee on Taxation, taking into account the comments submitted to the Congress (in written statements and in public hearing testimony before the House Committee on Ways and Means) that concerned changes that were technical in nature. The bill was developed with the assistance of the staffs of the Treasury Department and the Internal Revenue Service.

Section II of this pamphlet is organized in three parts: Part A summarizes the technical amendments to the Revenue Act of 1978; Part B summarizes the technical amendments to the Foreign Earned Income Act of 1978; and Part C summarizes the technical amendments to the Energy Tax Act of 1978. Amendments in the bill that relate to these Acts for which no descriptions are provided are clerical in nature. All of the amendments in the bill to the Black Lung Benefits Act of 1977 are clerical in nature and, consequently, no descriptions of these amendments are provided in this pamphlet. Section III discusses the overall revenue effect of the bill.

Several of the provisions contained in the Technical Corrections Act as it passed the House of Representatives affect the 1979 tax forms. Printing of the 1979 tax forms was scheduled prior to the consideration of the bill by the Finance Committee. In order to permit the printing of correct forms, on October 2, 1979, the Finance Committee agreed to several provisions in the House-passed bill that affect 1979 tax forms. The provisions of the House-passed bill that were adopted by the Finance Committee that are described in this pamphlet are numbers 34, 53, 54, 55, and 57 of the Technical Amendments to the Revenue Act of 1978, No. 1 of the Technical Amendments relating to the Foreign Earned Income Act of 1978, and No. 1 of the Technical Amendments relating to the Energy Tax Act of 1978.

II. DESCRIPTION OF THE BILL

A. TECHNICAL AMENDMENTS TO THE REVENUE ACT OF 1978

1. Coordination of amendments made by the Revenue Act of 1978 and the Energy Tax Act of 1978 (sec. 2 of the bill and secs. 46 and 48 of the Code)

Prior to the Revenue Act of 1978, the present investment tax credit rate of 10 percent was scheduled to decline to 7 percent (4 percent for utility property) on January 1, 1981. Under the Revenue Act of 1978, the 10-percent rate of the credit was made permanent for all taxpayers.

The provisions of the Code (sec. 46(a)(2)) which pertain to the rate of the credit also were amended and restated by the Energy Tax Act of 1978. Although the energy tax amendments were passed by the Congress before the amendments made by the Revenue Act of 1978, these two bills were signed into law by the President in reverse of the order these bills were passed by Congress.[1]

The order of enactment technically may have caused the 10-percent credit to again be temporary.

The bill would direct that, for purposes of applying the amendments made to the investment credit rate provisions by these two laws, the Energy Tax Act of 1978 will be deemed to have been enacted first. As a result, the 10-percent credit rate would be permanent as was intended by the Revenue Act of 1978.

2. Eligibility for earned income credit for persons claiming section 913 deductions (sec. 101(a)(1) of the bill and sec. 43(c)(1) of the Code)

Under present law, the earned income credit is not available to taxpayers who are entitled to exclude amounts from income under section 911 for the taxable year. This provision affects only those taxpayers who lived abroad during part of the year since the earned income credit generally is not available to those taxpayers whose principal place of abode for the taxable year is outside the United States. The Foreign Earned Income Act of 1978 established a new set of deductions under section 913 which are available generally to those taxpayers who formerly were entitled to the section 911 exclusion.

The bill would deny the earned income credit to taxpayers who claim deductions under section 913, as well as those who claim the benefits of section 911. Thus, the credit would continue to be unavailable to the same type of taxpayers who formerly were denied the credit because they qualified for section 911 exclusion. This provision would be effective for taxable years beginning after December 31, 1977.

[1] The Revenue Act of 1978 (P.L. 95-600) was signed into law first, on November 6, 1978, and the Energy Tax Act of 1978 (P.L. 95-618) then was signed into law on November 9, 1978.

3. Treatment of earned income credit as earned income under AFDC and SSI (secs. 101(a)(2)(A) and (B) of the bill and secs. 402 and 1612 of the Social Security Act)

Prior to the Revenue Act of 1978, the earned income credit was not taken into account as income for purposes of determining eligibility for, or the amount of, benefits or assistance under any Federal program or State or local program financed in whole or in part with Federal funds. The Act repealed this provision, effective in 1980. However, conforming changes were not made to the Social Security Act.

The bill would amend the Social Security Act to provide that the earned income credit will be treated as earned income for purposes of the aid to families with dependent children (AFDC) and supplemental security income (SSI) programs, effective for payments for months beginning after December 31, 1979. This treatment would apply to any refund of Federal taxes made by reason of the earned income credit and to any advance payments made by an employer.

4. Correction of effective date for advance payment of earned income credit (sec. 101(a)(2)(C) of the bill and sec. 105(g)(2) of the Act)

The Revenue Act of 1978 contained a new provision for advance payments of the earned income credit. The effective date of the provision as written in the Act was for wages paid after June 30, 1978.

The bill would correct a typographical error in the Act to provide that the provision is effective with respect to wages paid after June 30, 1979.

5. Relationship of section 85 of the Code to railroad unemployment compensation (sec. 101(a)(3) of the bill and sec. 128(a)(8) of the Code)

Prior to the Revenue Act of 1978, unemployment compensation was not included in gross income. The Act makes all types of unemployment compensation paid under government programs includible in gross income for taxpayers with incomes above specified amounts.

The bill would modify an existing cross reference in the Code to make it clear that railroad unemployment compensation benefits may be included in gross income for certain taxpayers.

6. Extension of deferred compensation rules to certain rural electric cooperatives and their trade organizations (sec. 101(a)(4) of the bill and sec. 457(d)(9) of the Code)

The Revenue Act of 1978 provided that employees and independent contractors who provide services for a State or local government, a rural electric cooperative (described in Code sec. 501(c)(12)), or an association of such cooperatives that maintains an eligible deferred compensation plan will be able to defer the inclusion in income of compensation as long as such deferral does not exceed certain prescribed annual limitations.

The Act provision did not apply to certain rural electric cooperatives in the Tennessee Valley Authority ("TVA") area which are exempt from taxation under section 501(c)(4) (but which, generally because of TVA requirements, cannot meet all the requirements for exemption under Code sec. 501(c)(12)). In addition, the provision did not apply to certain national and State associations of rural electric

cooperatives because some of their members are not domestic rural electric cooperatives and because some of the organizations are exempt from taxation as social welfare organizations (described in sec. 501(c)(4)) rather than as trade associations (described in sec. 501(c)(6)).

The bill would provide that the types of organizations eligible for these exclusion rules include (1) any organization which is exempt from tax under section 501(a)(4) and which is engaged primarily in providing electric service on a mutual or cooperative basis and (2) any organization described in section 501(c) (4) or (6) which is exempt from tax under section 501(a) and at least 80 percent of the members of which are rural electric cooperatives which are eligible for these rules.

7. Nondiscriminatory participation requirements for cafeteria plans (sec. 101(a)(5)(A) of the bill and sec. 125(g)(3)(B) of the Code)

Prior to the Revenue Act of 1978, a participant in a cafeteria plan was taxable only to the extent he or she elected taxable benefits under the plan if the plan was in existence on June 27, 1974. The Act made this favorable tax treatment applicable to all cafeteria plans meeting certain nondiscrimination standards, including a standard regarding the maximum number of years of employment which may be required as a condition of plan participation.

The bill would make it clear that the participation standard is based on time of employment rather than time of service.

8. Effective date of cafeteria plan provisions (sec. 101(a)(5)(B) of the bill and sec. 134(c) of the Act)

A provision in the cafeteria plan rules of the Revenue Act of 1978 specifies that amounts required to be included in income by a highly-compensated participant because a cafeteria plan does not satisfy nondiscrimination standards will be treated as received or accrued in the participant's taxable year in which the plan year ends. Because the cafeteria plan rules apply to participants' taxable years beginning after 1978, amounts contributed during 1978 under a fiscal-year cafeteria plan which does not satisfy the new nondiscrimination rules might have to be included in income in 1979 by highly-compensated participants. Thus, in certain cases, the cafeteria plan rules apply retroactively to contributions made in 1978.

The bill would make the cafeteria plan provisions of the Act effective for plan years, rather than for participants' taxable years, beginning after 1978. Thus, highly-compensated participants in fiscal-year plans would not have income solely because of the new cafeteria plan rules until 1980. In addition, to comply with the cafeteria plan rules, plans would not have to be amended until the beginning of the first plan year after 1978.

9. Normalization of the investment credit for contributions to an ESOP (sec. 101(a)(6)(A) of the bill and sec. 46(f)(9) of the Code)

Prior to the Revenue Act of 1978, the Code allowed an additional investment credit of up to one and one-half percent to an employer which made contributions to an ESOP (employee stock ownership

plan). However, this credit was not available to public utilities if the agencies which regulated them did not comply with normalization rules concerning this credit.

The Act extended the additional investment credit for ESOPs for an additional three years through the end of 1983 and revised the ESOP provisions. However, cross references to the normalization provisions applicable to the ESOP credit were not changed to reflect the revisions made by the Act.

The bill would correct these cross references to clarify that the anti-flow-through rules continue to apply to investment credits attributable to an ESOP.

10. Effective dates for ESOPs and leveraged employee stock ownership plans (sec. 101(a)(6)(B) of the bill and sec. 141(g) of the Act)

The Revenue Act of 1978 made certain changes to the rules governing ESOPs and leveraged employee stock ownership plans. The Act provided that these changes generally were effective with respect to qualified investment for taxable years beginning after December 31, 1978. The application of this general effective date was unclear with respect to several of the changes relating to ESOPs and with respect to the changes relating to leveraged employee stock ownership plans.

The bill would make clear the operation of the effective date provision for certain ESOP changes. The general effective date would be retained. Thus, the ESOP changes in the Act generally would apply with respect to qualified investment for taxable years beginning after December 31, 1978. In addition, special effective date provisions would apply to the ESOP provisions of the Act relating to (1) voting rights, (2) the right of an ESOP to distribute cash in lieu of employer securities (subject to the right of a participant to demand a distribution in the form of employer securities), and (3) put option requirements.

The voting rights provision would apply to plans to which the new ESOP provisions generally apply beginning with the first day of such application. An ESOP would be required to follow the new voting pass-through rules with respect to all employer securities held by it if additional employer securities were acquired by the ESOP on account of qualified investment made in a taxable year beginning after December 31, 1978.

The rules relating to the right of an ESOP to distribute cash in lieu of employer securities (subject to the right of a participant to demand a distribution in the form of employer securities) would apply to ESOP distributions after December 31, 1978, provided that the new ESOP rules generally have become applicable to the ESOP on account of qualified investment made after that date.

The ESOP put option requirements would apply to employer securities which are not readily tradable on an established market and which are acquired by an ESOP after December 31, 1978, on account of a qualified investment made after that date. In addition, the employer would be permitted to elect to have the new put option rules in the Act apply to all employer securities held by an ESOP which are not readily tradable on an established market. Under the bill, this election could be revoked only with the consent of the Secretary of the Treasury.

The bill also would allow taxpayers to elect irrevocably to accelerate the general effective date by a year. In such a case, the ESOP changes would apply with respect to qualified investment for taxable years beginning after December 31, 1977.

The bill also would provide effective dates for the changes made by the Act relating to leveraged employee stock ownership plans. These changes concern (1) voting rights, (2) put option requirements, and (3) the right of a leveraged employee stock ownership plan to distribute cash in lieu of employer securities (subject to the right of a participant to demand a disrtibution in the form of employer securities).

Under the bill, in the case of employer securities acquired by a leveraged employee stock ownership plan after December 31, 1979, the plan would be required (1) to pass through voting rights to plan participants on such securities, under certain circumstances, and (2) to give employees put options on employer securities which are not readily tradable on an establish market.

The right of a leveraged employee stock ownership plan to distribute cash in lieu of employer securities (subject to the right of a participant to demand a distribution in the form of employer securities) would apply to distributions after December 31, 1979.

11. Definition of qualifying employer security for leveraged employee stock ownership plans (sec. 101(a)(6)(C) of the bill and sec. 4975(e)(8) of the Code)

The Revenue Act of 1978 made leveraged employee stock ownership plans subject to certain special rules with respect to employer securities held by the plans. However, under the Act, the definition of employer securities for this purpose was not made clear.

The bill would make it clear that, for purposes of the rule governing a leveraged employee stock ownership plan, the term employer securities is defined in the same manner as in the case of an ESOP. This definition generally includes readily tradable common stock of the employer and preferred stock convertible into such readily tradable common stock. This amendment would be effective for stock acquired after December 31, 1979.

12. Nonrecognition of gain on contribution to ESOP (sec. 101(a)(6)(D) of the bill and sec. 409A(m) of the Code)

Prior to the Revenue Act of 1978, it was unclear whether gain would be recognized by a corporation making a contribution to an ESOP of an employer security issued by a related corporation. The Act provided that no gain would be recognized in such circumstances. However, for technical reasons, the rule in the Act did not apply to all required contributions of employer securities to an ESOP.

The bill would correct this technical deficiency to provide that no gain or loss is recognized to an employer on the required transfer of employer securities to an ESOP which it maintains.

13. Leveraged employee stock ownership plans may distribute cash in certain cases (sec. 101(a)(6)(E) of the bill and sec. 409A(h)(2) of the Code)

Under the Revenue Act of 1978, leveraged employee stock ownership plans are required to meet certain rules also applicable to ESOPs.

However, the statute is not clear whether, under these rules, a leveraged employee stock ownership plan which meets these rules may distribute cash in lieu of employer securities to a participant entitled to a distribution from the plan.

The bill would make it clear that, like an ESOP, a leveraged employee stock ownership plan may (subject to an employee's right to require a distribution in the form of employer securities) distribute cash in lieu of employer securities to an employee entitled to a distribution from the plan.

14. Matched employer and employee contributions must stay in plan (sec. 101(a)(6)(F) of the bill and sec. 409A(d) of the Code)

Prior to the Revenue Act of 1978, matched employer and employee contributions to an ESOP generally were required to remain in the plan for an 84-month period. However, it was unclear whether the same rule continued under the Act.

The bill would make it clear that the rule requiring matched employer and employee contributions to an ESOP to remain in the plan for an 84-month period generally is still applicable.

15. Coordination of deduction for estate tax attributable to income in respect of a decedent and income tax on lump sum distributions from retirement plans (sec. 101(a)(7) of the Act and sec. 691(c)(5) of the Code)

Under present law, lump sum distributions from qualified pension, profit-sharing, and stock bonus plans are eligible for special income tax treatment rather than being taxed at the taxpayer's regular tax rates for the year the distribution is received. With respect to the portion of the distribution attributable to an employee's participation in the plan after December 31, 1973, a special 10-year forward averaging formula is provided. With respect to the portion of the distribution attributable to the employee's participation before January 1, 1974, capital gain treatment is generally allowable.

When a beneficiary receiving a lump sum distribution on account of the death of an employee elects to be taxed under the 10-year averaging rules, the distribution is includible in the deceased employee's gross estate and the amount of the distribution is subject to an estate tax. The recipient of the distribution is allowed a separate income tax deduction for the death taxes attributable to that distribution (Code sec. 691(c)).

The Revenue Act of 1978 added a provision which coordinated this deduction for estate taxes with the capital gains deduction so that the amount of any capital gain which is income in respect of a decedent is offset by the deduction for estate taxes before the capital gains deduction is computed. However, the Act failed to take into account that the recipient of a death benefit distribution from a qualified retirement plan may be able to treat the distribution (or a portion thereof) under the special 10-year averaging provisions. The Act, therefore, did not provide a rule which coordinates the use of the special 10-year averaging method with the deduction for estate taxes.

The bill would provide that the amount of a death benefit distribution subject to 10-year averaging is reduced by the amount of the

death tax deduction attributable to the distribution. This would have the effect of reducing the amount of the distribution eligible for the special 10-year averaging formula by the death tax adjustment. The amendment would be effective for estates of decedents dying after the date of enactment of the bill.

16. Exclusion of certain employees from participation in simplified employee pensions (sec. 101(a)(9)(A) of the bill and sec. 408(k)(2) of the Code)

The Revenue Act of 1978 created a new type of individual retirement plan, known as a simplified employee pension. Employer contributions to simplified employee pensions must not discriminate in favor of employees who are officers, shareholders, or highly compensated. In testing employer contributions for discrimination, certain employees who are included in a collective bargaining unit or who are nonresident aliens may be excluded from consideration. However, the simplified employee pension rules may have required employers to include these employees in the group of employees who are entitled to share in employer contributions to simplified employee pensions.

The bill would permit certain employees who are included in a collective bargaining unit or who are nonresident aliens to be excluded from the group of employees who are entitled to share in employer contributions to simplified employee pensions.

17. Exemption from FICA and FUTA taxes for employer contributions to simplified employee pensions (sec. 101(a)(9)(B) of the bill and secs. 3121(a)(5) and 3306(b)(5) of the Code)

The Revenue Act of 1978 created a new type of individual retirement plan, known as a simplified employee pension. Under present law, employer contributions to the IRA (individual retirement account, annuity, or retirement bond) of an employee are considered remuneration subject to FICA and FUTA taxes, but employer contributions with respect to an employee to a tax-qualified plan are not subject to these taxes. The Act did not specify whether employer contributions to a simplified employee pension were subject to FICA or FUTA taxes.

Under the bill, an amount paid by an employer to an employee's individual retirement account or annuity would not be subject to FICA or FUTA taxes if the account or annuity is a simplified employee pension and there is reason to believe that the employee will be entitled to deduct the payments under the IRA rules applicable to simplified employee pensions. This amendment would be effective for payments made on or after January 1, 1979.

18. Clarification of rules relating to excess contributions to simplified employee pensions (sec. 101(a)(9)(C) of the bill and sec. 408(d)(5)(A) of the Code)

The rules relating to individual retirement accounts and annuities permit the withdrawal of an excess contribution (other than a rollover contribution) without the usual 10 percent additional income tax on early distributions to the extent no deduction was allowed for the contribution. The early distribution tax may apply, however, if the amount contributed for the year exceeds $1,750. No dollar limitation applies to an excess rollover contribution if the excess is attrib-

utable to certain erroneous information provided by the employer. Consequently, if an excess contribution is made by an employer to an individual retirement account or annuity of an employee under the simplified employee pension rules and the amount of the contribution is greater than $1,750, the 10 percent additional tax could apply.

The bill would permit an individual to withdraw excess employer contributions to a simplified employee pension free of the 10 percent additional tax, without regard to the $1,750 limitation.

19. Contributions to simplified employee pensions after age 70½ (sec. 101(a)(9)(D) of the bill and sec. 219(b)(7) of the Code)

The Revenue Act of 1978 created a new type of individual retirement plan, known as a simplified employee pension. Under the rules for simplified employee pensions, an employer may be obligated to contribute to the individual retirement account or annuity of an employee who has attained age 70½. In the event of such a contribution, under the usual rules for individual retirement accounts and annuities, such a contribution is includible in the gross income of the employee but the contribution is not deductible by the employee and is considered an excess IRA contribution.

The bill would allow an employee who has attained age 70½ to deduct employer contributions to the employee's individual retirement account or annuity if the account or annuity is a simplified employee pension.

20. Coordination of H.R. 10 plans and subchapter S corporation plans with simplified employee pensions (secs. 101(a)(9)(E) and (F) of the bill and secs. 404(h)(4) and 408(k) of the Code)

The Revenue Act of 1978 created a new type of individual retirement plan, known as a simplified employee pension. Under the Act, if an employer maintains a defined contribution H.R. 10 plan for a self-employed individual and contributes to a simplified employee pension for that individual, the limitation on the employer's deduction for the contribution to the H.R. 10 plan is reduced by the deduction allowed for the contribution to the simplified employee pension so that the limitation on the total amount set aside for that individual is not increased. The Act, however, did not provide corresponding rules with respect to defined benefit plans for self-employed individuals or with respect to plans for certain shareholder-employees of subchapter S corporations.

Under the bill, the limitation on deductions for contributions to a defined contribution plan by a subchapter S corporation on behalf of a shareholder-employee would be reduced by the amount deducted by the employer for contributions to the simplified employee pension of that employee. Also, the bill would not allow an employer who maintains a defined benefit plan for self-employed individuals or shareholder-employees to contribute to simplified employee pensions.

21. Special limits on benefits under certain defined benefit pension plans (sec. 101(a)(10)(A) of the bill and sec. 415(b)(7) of the Code)

Under the Code, limits are provided for benefits and contributions under tax-qualified plans, individual retirement plans, and tax-sheltered annuities. Generally, under those rules, benefits under a de-

fined benefit pension plan may not exceed 100 percent of a participant's average high 3-year compensation. An exception to the 100-percent limit was provided by the Revenue Act of 1978 for participants in certain collectively bargained plans, but the exception was not designed for situations in which an employee participates in more than one plan maintained by a single employer.

Under the bill, the exception to the 100-percent limit would be restricted to an employee who is a participant in a collectively bargained plan where the employee does not participate in any other plan (subject to the limits on benefits or contributions) maintained by an employer who maintains the collectively bargained plan.

22. Limitations for certain collectively bargained pension plans (sec. 101(a)(10)(B) of the bill and sec. 415(b)(7)(C) of the Code)

Prior to the Revenue Act of 1978, benefits under a qualified defined benefit pension plan generally were limited to the lesser of 100 percent of pay or $75,000 per year, adjusted for inflation since 1974 ($98,100 for 1979). The Act provides that the 100-percent-of-pay limit is disregarded in the case of certain large collectively bargained plans under which each employee who serves during a particular year earns the same pension credit (determined without regard to age at retirement or date of retirement).

The bill would make clear that the exception to the 100-percent-of-pay limit applies in the case of certain large collectively bargained plans where the amount of the pension credit for a particular employee is based solely on one or more of the following factors: (1) the length of service, (2) the particular years during which service was rendered, (3) the age at retirement, and the date of retirement.

23. Effective date of section 403(b) annuity rollovers and transitional rule for payments received in 1978 (secs. 101(a)(12) (A) and (B) of the bill and sec. 156(d) of the Act)

Prior to the Revenue Act of 1978, recipients of distributions under a tax-sheltered annuity purchased by an employer which is a tax-exempt organization or a public school were not eligible to defer tax on those distributions by rolling them over to an IRA (individual retirement account, annuity, or retirement bond). The Act permitted a recipient of a "lump sum distribution" from a tax-sheltered annuity to defer tax on the distribution by rolling it over within 60 days of receipt to an IRA or to another tax-sheltered annuity. Due to a clerical error, the rollover provision, as enacted, applied to distributions or transfers made after December 31, 1978, in taxable years beginning after that date.

The bill would make the tax-sheltered annuity rollover provisions effective for distributions or transfers made after December 31, 1977, in taxable years beginning after that date. In addition, the bill would provide that the recipient of a qualifying distribution in 1978 will have until December 31, 1980, to complete a rollover to either an IRA or another tax-sheltered annuity. Upon completion of the rollover, the recipient of a qualifying distribution in 1978 will be able to amend his or her 1978 income tax return to take into account the portion of the distribution originally included in income which is no longer subject to tax because of the rollover.

24. Spousal rollovers (sec. 101(a)(13)(C) of the bill and sec. 402 (a)(7)(A) of the Code)

Under the Revenue Act of 1978, a surviving spouse receiving a lump sum death benefit distribution from a tax-qualified retirement plan was, for the first time, permitted to make a rollover of the distribution to an IRA. As enacted, however, rollovers were not permitted for complete distributions to surviving spouses upon termination of tax-qualified retirement plans.

The bill would make it clear that any lump sum distribution from, or complete distribution upon termination of, a qualified retirement plan which is paid to the surviving spouse of a deceased plan participant, and which is attributable to the participant, is eligible for rollover treatment.

25. Extension of transitional rule relating to removal of five-year requirement for a rollover (sec. 101(a)(13)(D) of the bill and sec. 157(h)(3)(B) of the Act)

Prior to the Revenue Act of 1978, an individual was required to be a participant in a tax-qualified retirement plan for five full taxable years in order to qualify for a rollover to an IRA (or to another tax-qualified retirement plan) of a lump sum distribution from the plan. The Act eliminated this five-year requirement for taxable years beginning after December 31, 1977, and permitted individuals denied the opportunity for a rollover during 1978, because of the five-year requirement, to complete their rollovers at any time before January 1, 1979.

The bill would permit individuals denied rollover treatment of distributions from tax-qualified retirement plans during 1978 solely because of the five-year plan participation requirement to make such rollovers until the end of 1980.

26. Correction of attribution rules for at risk limitations (sec. 102(a)(1)(A) of the bill and sec. 465(a) of the Code)

Prior to the Revenue Act of 1978, the only types of corporations to which the at risk rules (Code sec. 465) applied were subchapter S corporations and personal holding companies. The Act extended the application of the at risk rules to certain closely held corporations (even though they would not qualify as personal holding companies and had not made subchapter S elections). The closely held corporations to which these rules were extended included any corporation in which five or fewer individuals owned 50 percent or more of the stock. However, in determining whether this ownership test was met, the attribution rules under section 318 of the Code, rather than under section 544 of the Code, were to be applied.

In general, the attribution rules of section 318 are much narrower than those of section 544, which, *inter alia*, provide for attribution of one partner's stock to another partner in the same partnership and for broader family and corporate attribution. Under section 544, stock in one corporation (the "subsidiary") owned by another corporation (the "parent") is attributed to the parent's shareholders in proportion to the shareholders' ownership in the parent. However, under section 318, the stock of a subsidiary corporation is considered as owned by a shareholder of the parent corporation only if the shareholder owns 50 percent or more in value of the stock of the parent corporation.

Also, under section 544, an individual is considered as owning stock owned directly or indirectly by his brothers and sisters, spouse, ancestors, and lineal decendants; however, under section 318, an individual is treated as owning only the stock owned directly or indirectly by his spouse, children, grandchildren, and parents.

The Act adopted the attribution rules of section 318 primarily because it was thought inappropriate to attribute one partner's stock in a corporation to another partner in the same partnership. However, in adopting the attribution rules of section 318, the Act inadvertently permitted exemption from the at risk rules where the stock ownership of the corporation warranted application of the at risk rules (e.g., where the corporation was a personal holding company but did not meet the section 318 attribution rules).

The bill would provide generally that, in determining whether five or fewer individuals own 50 percent or more of stock of a corporation under the at risk rules, the rules of section 544 which relate to attribution of stock ownership are to be applied. However, those rules of section 544 relating to attribution of stock ownership from one partner to another would not be applied.

27. Clarification of recapture rules of at risk provision (sec. 102(a)(1)(B) of the bill and sec. 465(d) of the Code)

Under a literal interpretation of the law prior to the Revenue Act of 1978, the at risk rules may have only required the taxpayer to be at risk at the end of the taxable year for which losses are claimed. Thus, arguably, subsequent withdrawals of amounts originally placed at risk may have been made without the recapture of previously allowed losses. The Act added provisions which require the recapture of previously allowed losses when, and to the extent, the amount at risk is reduced below zero. However, the Act provides that this income is treated as income from the activity to which the at risk rule applies and thus can be used to shelter additional losses from the activity if the losses are incurred in the year in which the recapture occurs (or are suspended losses which are treated as having been incurred in such year).

In other words, because recapture income under the recapture of loss rules is considered income from the activity, any losses from the activity for the year of recapture (including losses carried over from previous years) can be offset against the recapture income without taking into account the amount of the at risk basis. Thus, notwithstanding a negative at risk basis, losses during the year of recapture, to the extent of the amount of recapture income, can be deducted. Moreover, the at risk basis is left at a negative amount, instead of being brought back up to zero by the amount of recapture income (the recapture income, instead, having been applied against the loss).

The bill would provide that such recapture income is not to be treated as income from the activity for purposes of determining whether current losses (or suspended losses) are allowable.

28. Clarification of limitation on recapture of losses under at risk provisions (sec. 102(a)(1)(C) of the bill and sec. 465(e)(2)(A) of the Code)

The Revenue Act of 1978 modified the at risk rules to provide for a recapture of losses where the amount at risk is less than zero. These re-

capture of loss rules were intended to apply only to losses relating to taxable years beginning after December 31, 1978. Because of a possible ambiguity in the provision governing the adjustments which reduce the at risk basis in an activity (Code sec. 465(b)(5)), it is unclear whether the adjustment for losses relating to a taxable year would be made as of the last day of such taxable year or as of the first day of the following taxable year. Consequently, it is unclear whether a loss relating to a taxable year beginning before December 31, 1978, but possibly reflected in an at risk basis adjustment as of the first day of a taxable year beginning after December 31, 1978, would be subject to the recapture of loss rules.

The bill would clarify the application of the recapture of loss provision (Code sec. 465(e)(2)) to indicate that it applies only to losses for taxable years beginning after December 31, 1978, and not to at risk basis adjustments possibly made after that date which relate to losses for taxable years beginning before December 31, 1978.

29. Waiver of controlled group rule where there is substantial leasing activity (sec. 102(a)(1)(D) of the bill and sec. 465(c) of the Code)

The Tax Reform Act of 1976 limited the amount of deductions in excess of income from certain types of activities to the amount the taxpayer has at risk. This specific at risk limitation (Code sec. 465) applied only to individuals, subchapter S corporations, and personal holding companies.

The Revenue Act of 1978 broadened the at risk rules to all types of activities except real estate. In addition, the Act applied the at risk limitation to closely held corporations. The Act contains an exception to the at risk limitation for closely held corporations actively engaged in equipment leasing operations. For a corporation to qualify for this exception, at least 50 percent of its gross receipts must be derived from equipment leasing. In order to prevent abuse, the Act provided that the 50-percent test is to be applied by looking at the gross receipts of all the members of a controlled group of corporations.

Despite the exception for equipment leasing, the Act applied the at risk limitations to a number of substantial active equipment leasing operations. This has occurred because the gross receipts from equipment leasing of some members of a controlled group of corporations, while substantial in an absolute sense, constitute less than 50 percent of the total gross receipts of all the members of the controlled group. In many of these situations, some of the corporations in the group have significant active leasing activities (as measured by employees, receipts, and number of transactions).

The bill would exempt certain active equipment leasing activities carried on by members of a closely held controlled group of corporations, if the following standards are met for the current taxable year and each of the two preceding taxable years:

(*1*) *Employees:* The group had at least three full time employees during the entire year who devoted substantially all of their services for equipment leasing activities only to group members that derived at least 80 percent of their gross receipts from leasing and selling equipment.

(*2*) *Number of transactions:* The group members that derived at least 80 percent of their gross receipts from leasing and selling equipment had, in the aggregate, entered into at least five separate equipment leasing or sales transactions.

(*3*) *Gross receipts:* The group members that derived at least 80 percent of their gross receipts from leasing and selling equipment had, in the aggregate, at least $1,000,000 of gross receipts from leasing and selling equipment.

If all these standards are met, the "controlled group" rule would not be applicable. Instead, the active business test (based on gross receipts) currently in the statute would be applied to the members on a corporation-by-corporation basis, and the 50-percent gross receipts requirement would be increased to 80 percent for each member.

30. Clarification of normalization provisions for purposes of investment tax credit (sec. 103(a)(1)(A) of the bill and sec. 312(c)(2) of the Act)

The Revenue Act of 1971 added rules to provide for the normalization of the investment tax credit for public utility property which qualified for the investment credit after the credit was restored in 1971. The Revenue Act of 1978 repealed the rules relating to the restoration of the credit in 1971 as "deadwood." As a result, it is not clear whether the normalization rules apply to public utility property placed in service before 1971.

The bill would clarify the application of the normalization rules to public utility property so that the normalization provisions would apply to public utility property only for the period to which the restored investment credit applies.

31. Coordination of investment credit rules for pollution control equipment (sec. 103(a)(2) of the bill and sec. 46(c)(5)(B) of the Code)

The Energy Tax Act of 1978 provides a 10-percent investment credit for investments in certain energy property acquired after September 30, 1978 and before January 1, 1983. This credit is in addition to the 10-percent regular investment credit for which energy property also may qualify. Qualifying energy property includes pollution control equipment which is required to be installed in connection with certain other energy property. However, where energy property, including pollution control equipment, is financed in whole or in part by tax-exempt industrial development bonds, a reduced credit of 5-percent is allowed on qualified investment.

The Revenue Act of 1978 revised the rules concerning investment credits for pollution control facilities where the taxpayer elects to amortize the cost of pollution control facilities over 5 years. Under these rules, where 5-year amortization is elected for pollution control facilities which also are financed with tax-exempt industrial development bonds, the taxpayer's qualified investment for purposes of investment credits is one-half of the investment which is subject to the 5-year amortization election.

Where pollution control equipment which is energy property is subject both to the generally applicable rule which limits qualified investment and to the reduction in the energy credit percentage, the effective rate of the energy credit will be only 2.5 percent.

The bill would correct this unintended result of the changes made by the two 1978 tax acts so that pollution control equipment in this situation will be allowed an energy investment credit of 5 percent.

32. Treatment of noncorporate lessors for purposes of the investment credit for rehabilitation expenditures (sec. 103(a)(3)(A) of the bill and sec. 46(e)(3) of the Code)

Under the investment credit provisions generally, a limitation exists concerning the availability of the credit for noncorporate lessors. Under this limitation, the credit generally is not available to a noncorporate lessor of qualified leased property unless either (1) the noncorporate lessor produced the property or (2) the lease term is less than 50 percent of the useful life of the property and the lessor's ordinary and necessary business expenses in connection with the property are more than 15 percent of the rental income produced by the property during the first 12 months of the lessee's use. This limitation was designed to deal with equipment leasing tax shelters which often involve long-term leases on a net basis (i.e., the lessee pays all expenses incident to the maintenance and operation of the leased property).

The Revenue Act of 1978 makes the investment credit generally available to expenditures incurred after October 31, 1978, for rehabilitating older business and commercial buildings (except those used for residential purposes). However, newly rehabilitated buildings, which may have had only marginal usefulness before they were rehabilitated, often will be leased under long-term or net leases in order to enhance the lessor's ability to recover the substantial costs of rehabilitation. The application of the noncorporate lessor limitation will deny the investment tax credit in many situations where taxpayers have incurred substantial expenditures in rehabiliating older buildings.

The bill would make the noncorporate lessor limitation inapplicable for purposes of the investment credit on rehabilitation expenditures.

33. Coordination of regular investment credit for rehabilitation expenditures with energy investment credit (sec. 103(a)(3)(B) of the bill and sec. 48(g)(2)(B) of the Code)

The Revenue Act of 1978 made the regular investment credit available to rehabilitation expenditures for certain buildings which are at least 20 years old. One of the provisions of the Act excludes from the definition of qualified rehabilitation expenditures those expenditures for property which qualify as investment credit property under other investment credit rules. This provision would exclude from the regular investment credit certain rehabilitation expenditures which also qualify as expenditures for energy property eligible for the energy investment credit.

The bill would make both the energy investment credit and the regular investment credit available where rehabilitation expenditures also qualify as expenditures for energy property.

34. Rules for work incentive credit and jobs credit for cooperatives (sec. 103(a)(4) of the bill and secs. 50B(f) and 52(f) of the Code)

Prior to the Revenue Act of 1978, special rules applied for purposes of determining the amounts of the work incentive (WIN) credit and

the general jobs credit which could be used by cooperatives. These special rules applied the same rules under which the amount of investment credit for cooperatives was determined. The Act revised the rules pertaining to the investment credit for cooperatives but no change was made to the rules pertaining to the WIN and jobs tax credits for cooperatives.

The bill would extend the new rules for the investment credit for cooperatives to the WIN and jobs credits.

This amendment already has been adopted by the Finance Committee. This amendment affects the 1979 tax forms which were printed prior to the time consideration of H.R. 2797 was scheduled by the Finance Committee. The Finance Committee adopted the amendment on October 2, 1979, in order that this amendment could be reflected in the 1979 tax forms.

35. Correction of expiration date of targeted jobs credit (sec. 103(a)(5)(A) of the bill and sec. 51(c)(4) of the Code)

The Revenue Act of 1978 provided for a targeted jobs credit which allows employers a tax credit for employing certain categories of individuals. Due to a clerical error, the Act provides that the targeted jobs credit is to expire for wages paid after December 31, 1980.

The bill would correct the clerical error to provide that the credit may be claimed for wages paid or incurred up to and including December 31, 1981.

36. Clarification of effective date for election of jobs credit (sec. 103(a)(5)(B) of the bill and sec. 321(d) of the Act)

The Revenue Act of 1978 provides that the jobs credit is elective, rather than mandatory as under prior law. However, the Act did not contain a special effective date for this provision to permit taxpayers to retroactively revoke the election.

The bill would correct this error in the Act to provide that the election provision is effective for taxable years ending after December 31, 1976.

37. Clarification of effective date for newly targeted groups under jobs credit (sec. 103(a)(5)(C) of the bill and sec. 321(d)(2)(A) of the Act)

The Code, prior to the Revenue Act of 1978, provided a jobs credit to encourage employers to expand their workforces and an extra credit was provided for hiring persons referred under vocational rehabilitation programs. The Act amended the jobs credit to provide that, effective for amounts paid or incurred after December 31, 1978, the credit would be available only for the employment of specific target groups of individuals. For individuals in newly targeted groups (i.e., all individuals in target groups except persons referred under vocational rehabilitation programs for whom the taxpayers claimed credit under prior law), the credit is available only for persons first hired by the employer after September 26, 1978.

The bill would make clear that the effective date provision of the Act which relates to newly targeted groups applies only for purposes of the amendments made by the Act. Thus, with respect to a member of a newly targeted group who first begins work for an employer before January 1, 1979, the employer would be allowed whatever credit was

available under prior law for wages paid or incurred before January 1, 1979. For the purpose of amounts paid or incurred on or after that date, the credit will be allowed with respect to such an individual only if he or she was first hired after September 26, 1978, and this individual would be treated as beginning work on January 1, 1979, or the date hired, whichever is later.

38. Clarification of transitional rule for fiscal year taxpayers claiming jobs credit (sec. 103(a)(5)(D) of the bill and sec. 321(d)(3) of the Act)

The Revenue Act of 1978 includes a transitional rule to coordinate the effective date of the targeted jobs credit for 1979 with the expiration of the prior general jobs tax credit at the end of 1978 for fiscal year taxpayers.

The bill would clarify that, under the transitional rule, a taxpayer with a fiscal year beginning in 1978 will compute his total credit for that fiscal year by (1) determining his general jobs credit under prior law (but without regard to the 100 percent of tax liability limitation) for wages paid in 1978 and his targeted jobs credit under the Act (also without regard to the 100 percent of tax liability limitation) for wages paid or incurred in 1979, (2) adding the two amounts together, and then (3) applying the 100 percent of tax liability limitation to the sum.

39. Clarification that FUTA wages are to be treated as including remuneration of youths participating in cooperative education programs (sec. 103(a)(5)(E) of the bill and secs. 51(d)(8)(D) and 51(c) of the Code)

Under present law, one of the targeted groups for purposes of the targeted jobs credit is youth participating in a qualified cooperative education program. In general, wages eligible for the targeted jobs credit are Federal Unemployment Tax Act (FUTA) wages. Section 3306(c)(10)(C) excludes services performed by cooperative education students under the age of 22 from coverage under FUTA. Thus, although cooperative education students of ages 16 through 18 comprise an eligible target group, employers are not able to claim a credit with respect to the wages paid to them.

The bill clarifies that wages paid to youths participating in cooperative education programs, although not FUTA wages, are eligible for the targeted jobs credit.

40. Clarification of effective date for WIN-Welfare recipient tax credit for fiscal year taxpayers (secs. 103(a)(6)(A) of the bill and sec. 322(e)(1) of the Act)

Prior to the Revenue Act of 1978, the amount of WIN credit available to any employer was limited to $50,000 of tax liability plus one-half of tax liability in excess of $50,000. The Code contained rules for allocating amount between married individuals filing separately, among members of a controlled group, and between an estate or trust and its beneficiaries. The Act increased the limitation on the credit amount to 100 percent of tax liability, effective for taxable years beginning after December 31, 1978. Under the Act, it is unclear whether

the related rules for apportioning the $50,000 amount are effective during the entire taxable year of fiscal year 1978–79 taxpayers.

The bill specifies that for purposes of applying the prior law tax liability limitation to a taxable year beginning before January 1, 1979, the prior law rules relating to the apportionment of the $50,000 amount shall apply.

41. Clarification of transitional rule for AFDC recipients and WIN registrants hired after September 26, 1978 (sec. 103(a)(6)(B) of the bill and sec. 322(e)(2) of the Act)

The Code, prior to the Revenue Act of 1978, provided a credit to employers who hired certain AFDC recipients and WIN registrants. The Act amended the credit in several respects, and the amendments generally are effective for work incentive program expenses paid or incurred after December 31, 1978. Under the Act, eligible employees hired after September 26, 1978, are to be treated as having first begun work for the employer no earlier than January 1, 1979. However, it is unclear whether an employer is entitled to whatever credit was available under prior law for wages paid or incurred before January 1, 1979, with respect to AFDC recipients and WIN registrants.

The bill clarifies that the effective date provision which relates to AFDC recipients and WIN registrants hired after September 26, 1978, applies only for purposes of the amendments made by the Act. Thus, with respect to such an employee who first begins work for an employer before January 1, 1979, the employer would be allowed whatever credit was available under prior law for wages paid or incurred before January 1, 1979. For the purpose of amounts paid or incurred on or after January 1, 1979, such an employee would be treated as beginning work on January 1, 1979, and any wages paid or incurred after December 31, 1978, with respect to this employee would be considered to be attributable to services rendered after that date.

42. Effective date for limit on ordinary loss deduction for small business corporation stock (sec. 103(a)(7) of the bill, sec. 1244 of the Cole, and sec. 345(e) of the Act)

Prior to the Revenue Act of 1978, the Code provided that, if certain individual shareholders realized a loss on the disposition of certain stock (sec. 1244 stock), it would be treated as an ordinary loss. Under prior law, the maximum amount of ordinary loss from the disposition of section 1244 stock that could be claimed in any taxable year was $25,000, except for married taxpayers filing joint returns, in which case ordinary loss treatment was limited to $50,000.

In general, the Act increased the amount of section 1244 stock that a qualified small business corporation could issue, simplified and liberalized some of the conditions which must be satisfied for stock to qualify as section 1244 stock, and increased the amount of loss that certain shareholders could treat as an ordinary loss rather than as a capital loss. Under the Act, the maximum amount that could be treated as an ordinary loss was increased to $50,000; in the case of a husband and wife filing a joint return for the taxable year in which the loss is incurred, the maximum amount that may be treated as an ordinary loss was increased to $100,000.

Under the Act, these provisions applied to common stock issued after the date of enactment. This effective date is appropriate for the

changes in requirements for qualifying stock; however, as drafted, the Act did not increase the limitation on the amount of loss on previously issued section 1244 stock which could be treated as an ordinary loss in a taxable year. Rather, it created two separate limitations, one for common stock issued prior to the date of enactment and another for stock issued after the date of enactment (November 6, 1978).

The bill would amend the effective date of the provisions relating to the limitations on the amount of loss on section 1244 stock which may be treated as an ordinary loss by providing that the amendments relating to the ordinary loss limitations for individuals are applicable to taxable years beginning after December 31, 1978, whether or not the stock was issued before or after the effective date of the Act.

The bill also provides that, for taxable years beginning before December 31, 1978, the increased dollar limitations apply only with respect to losses on section 1244 stock issued after November 6, 1978.

43. Clarification of the club dues limitation on the nondeductibility of entertainment facility expenses (sec. 103(a)(8) of the bill and sec. 274(a)(2)(C) of the Code)

Prior to the Revenue Act of 1978, expenses incurred with respect to entertainment facilities were deductible if they were ordinary and necessary, the facility was used primarily for the furtherance of the taxpayer's business (i.e., more than 50 percent of the time that it was used), and the expense in question was related directly to the active conduct of the taxpayer's business. For this purpose, entertainment facility expenses included dues or fees paid to any social, athletic, or sporting club or organization.

The Act provided generally that no deduction was allowable for any entertainment facility expense. Contrary to the intent of the conferees, the Act provided an exception only for country club dues which meet the business test from this disallowance rule.

The bill would modify the exception from the facility expense deduction disallowance rule provided in the Act so that the exception would apply to all social, athletic, and sporting club dues which meet the business test.

44. Application of withholding tax to medical reimbursements (sec. 103(a)(10)(A) of the bill and sec. 3401(a)(19) of the Code)

Prior to the Revenue Act of 1978, medical reimbursements paid to, or on behalf of, an employee under a self-insured medical reimbursement plan of an employer generally were excluded from the employee's gross income and were not subject to withholding tax. Under the Act, such payments may be fully or partly includible in an employee's gross income for a year if the medical reimbursement plan discriminates in favor of highly compensated individuals for that year. In some cases, it may not be possible to make a determination as to the amount which is includible in gross income until after the year has ended.

The bill would clarify present law by continuing the withholding tax exclusion for reimbursements to an employee under a self-insured medical reimbursement plan, if it is reasonable to believe that the employee will be able to exclude the payment from gross income under the rules applicable to such plans.

45. Clarification of nondiscriminatory eligibility classification for medical reimbursement plans (sec. 103(a)(10)(B) of the bill and sec. 105(h)(3)(A) of the Code)

Prior to the Revenue Act of 1978, self-insured medical reimbursement plans were not subject to statutory nondiscrimination rules. Under the Act, nondiscrimination rules regarding eligibility were added, but it was not made clear whether the group in whose favor discrimination was prohibited consists of all highly compensated individuals employed by an employer or of only those who are plan participants.

The bill would make it clear that the nondiscrimination rule regarding eligibility for self-insured medical reimbursement plans takes into account all highly compensated individuals employed by the employer.

46. Clarification of excess reimbursement test under medical reimbursement plans (sec. 103(a)(10)(C) of the bill and sec. 105(h)(7)(A) of the Code)

Prior to the Revenue Act of 1978, medical reimbursements paid to, or on behalf of, an employee under a self-insured medical reimbursement plan of an employer generally were excluded from the employee's gross income. Under the Act, such payments may be fully or partly includible in an employee's gross income for a year if the medical reimbursement plan discriminates in favor of highly compensated individuals for that year. However, under the Act, the discrimination tests for measuring the amount of reimbursements under a particular benefit are not the same as the tests for determining whether that particular benefit is discriminatory.

The bill would conform the rules for measuring excess reimbursements under a self-insured medical reimbursement plan to the rules prohibiting discrimination in favor of highly compensated individuals under such plans.

47. Clarification of effective date for medical reimbursement plans (sec. 103(a)(10)(D) of the bill and sec. 366(b) of the Act)

Under the rules provided by the Revenue Act of 1978 for medical reimbursement plans, excess reimbursements made during a plan year are includible in the gross income of a highly compensated individual for the taxable year in which (or with which) the plan year ends. Because the rules apply for taxable years beginning after December 31, 1979, excess reimbursements made during 1979, in a plan year beginning after December 31, 1978, and ending after December 31, 1979, will be includible in the 1980 gross income of a highly compensated individual whose taxable year is the calendar year.

The bill would provide that the medical reimbursement plan rules apply only to reimbursements paid after December 31, 1979. However, in determining the taxability of reimbursements made in that plan year during 1980, the employee coverage and benefits provided by a plan for its plan year beginning in 1979 and ending in 1980, as well as reimbursements made in that plan year during 1979, will be taken into account.

48. Clarification of the effective date of the increased capital gains deduction (sec. 104(a)(2)(A) of the bill and sec. 1202(c) of the Code)

The Revenue Act of 1978 increased the capital gains deduction from 50 to 60 percent effective for sales or exchanges after October 31, 1978. The Act, however, was unclear as to the amount of the deduction which was to be allowed in the case of post-effective date receipts of payments attributable to pre-effective date transactions, e.g., installment sales.

The bill would clarify that post-effective date receipts of payments attributable to pre-effective date transactions are entitled to the increased capital gains deduction where the income is properly taken into account during a period after October 31, 1978.

49. Clarification of the alternative tax for noncorporate capital gains (sec. 104(a)(2)(B) of the bill and sec. 1201 of the Code)

Prior to the Revenue Act of 1978, a noncorporate taxpayer generally deducted from gross income 50 percent of any net capital gain, and the balance of the gain was taxed at the regularly applicable ordinary income rates. However, a partial alternative tax of 25 percent on the first $50,000 of net capital gain could apply, in lieu of taxing 50 percent of the gain at the regular rates, if it resulted in a lower tax than that which was produced by the regular method.

The Act repealed the noncorporate alternative tax for taxable years beginning after December 31, 1978. However, the Act inadvertently failed to conform the computation of each partial tax (for periods prior to its repeal) to reflect the increase in the capital gains deduction.

The bill would conform the calculation of the alternative tax to reflect the Act's increase in the capital gains deduction.

50. Clarification of the application of the effective date of the capital gains changes to amounts received from certain conduits (sec. 104(a)(2)(C) of the bill and secs. 1201(c)(2) and 1202(c)(1) of the Code)

The Revenue Act of 1978 increased the net capital gains deduction for noncorporate taxpayers from 50 to 60 percent, and decreased the corporate alternative tax rate from 30 to 28 percent. The former provision was effective with respect to post-October 31, 1978, gains and losses, and the latter provision was effective for post-December 31, 1978, gains and losses. However, the Act was unclear as to the applicability of these provisions to the capital gains of certain conduits whose income is taxed to another party where the date that the gains are includible in income by such other party is on or after the Act's effective date.

The bill would provide that, in applying the increased capital gains deduction or the reduced corporate alternative tax rate, the determination of the period for which gain or loss is properly taken into account must be made at the entity level. Therefore, in the case of pass-through entities, the proper capital gains deductions of an individual will be determined with reference to the time when those gains were taken into account by an entity rather than when a distribution was made, or was deemed to be made, by the entity to that individual. For purposes of applying this rule, "pass-through entities" are regulated investment

companies, real estate investment trusts, electing small business corporations, partnerships, estates, trusts, and common trust funds. This entity level determination would apply to taxable years of the recipient beginning before November 1, 1979 (or January 1, 1980, in the case of a corporation).

51. Clarification of the effective date of the reduced corporate alternative capital gains rate (sec. 104(a)(3)(A) of the bill and sec. 1201(c) of the Code)

The Revenue Act of 1978 reduced the corporate alternative tax rate for capital gains from 30 to 28 percent effective for sales or exchanges after December 31, 1978. The Act, however, was unclear as to the rate which was to apply in the case of post-effective date receipts of payments attributable to pre-effective date transactions, e.g., installment sales.

The bill would clarify that post-effective date receipts of payments attributable to pre-effective date transactions generally are subject to the reduced corporate alternative tax rate where the income is properly taken into account during a period after December 31, 1978.

52. Undistributed capital gains of regulated investment companies (sec. 104(a)(3)(B) of the bill and sec. 852(b) of the Code)

Under present law, regulated investment companies (commonly called "mutual funds") are allowed a deduction for income and capital gains that are distributed to its shareholders if certain requirements are met. In the case of capital gains, present law allows an alternative treatment that does not require the distribution of the capital gain to shareholders. Under the alternative treatment, the regulated investment company pays the regular corporate tax on the capital gain; the shareholder includes the capital gain in his income, is given credit for the capital gains taxes paid by the regulated investment company, and increases his basis in his shares of the regulated investment company by a specified percentage of the capital gain. The specified percentage under present law is 70 percent and is designed to be the excess of the capital gain taken into income by the shareholder over the amount of credit given the shareholder for the capital gains taxes paid by the regulated investment company. When the rate of tax on capital gains of corportions was decreased in the Revenue Act of 1978 from 30 percent to 28 percent, no corresponding adjustment was made to the specified percentage of basis adjustment.

The bill would increase the specified percentage of basis adjustment to stock in a regulated investment company to reflect undistributed capital gains from 70 percent to 72 percent.

53. Clarification that carryovers may not reduce alternative minimum taxable income (sec. 104(a)(4)(A) of the bill and sec. 55(b)(1) of the Code)

The Revenue Act of 1978 imposed an alternative minimum tax which is payable by an individual to the extent the gross alternative tax exceeds the regular tax as increased by the "add on" minimum tax. The alternative minimum tax base is generally the sum of an individual's gross income, adjusted itemized deductions, and capital gains, reduced by deductions allowed for the taxable year. In certain circum-

stances, it is possible that a deduction may reduce the alternative minimum taxable income base for a taxable year and still be available as a carryback or carryover to reduce taxable income in another taxable year.

The bill would deny the use of a deduction against the alternative minimum taxable income base if the deduction is available as a carryover or carryback to another taxable year.

This amendment already has been adopted by the Finance Committee. This amendment affects the 1979 tax forms which were printed prior to the time consideration of H.R. 2797 was scheduled by the Finance Committee. The Finance Committee adopted the amendment on October 2, 1979, in order that this amendment could be reflected in the 1979 tax forms.

54. Foreign tax credit allowable against alternative minimum tax (secs. 104(a)(4) (B) and (C) of the bill and secs. 55(c) and (b) of the Code)

The Revenue Act of 1978 imposed an alternative minimum tax but allowed a foreign tax credit against the tax.

The bill would revise the foreign tax credit rules to provide greater clarity, but no substantive changes are made. The bill would make it explicit that the credit may not exceed the amount of the alternative minimum tax. In addition, the definition of alternative minimum taxable income from sources without the United States would be revised to define more clearly the adjustments to be made to gross income.

This amendment already has been adopted by the Finance Committee. This amendment affects the 1979 tax forms which were printed prior to the time consideration of H.R. 2797 was scheduled by the Finance Committee. The Finance Committee adopted the amendment on October 2, 1979, in order that this amendment could be reflected in the 1979 tax forms.

55. Clarification of alternative minimum taxable income to taxpayers not itemizing deductions (sec. 104(a)(4)(D) of the bill and sec. 55(b) of the Code)

The Revenue Act of 1978 imposed an alternative minimum tax which is payable by an individual to the extent the gross alternative tax exceeds the regular tax as increased by the "add on" minimum tax. The alternative minimum tax base is generally the sum of an individual's gross income, adjusted itemized deductions, and capital gains, reduced by deductions allowed for the taxable year.

In the case of a taxpayer who does not elect to itemize deductions, no itemized deductions are allowed for the taxable year. In computing the regular income tax, a bracket is included in the tax tables to provide the taxpayer the benefit of a "standard deduction." No comparable provision is included in the computation of the alternative minimum tax.

The bill would provide that a taxpayer who does not elect to itemize deductions will be entitled to a deduction equal to the zero bracket amount (formerly the "standard deduction") in computing the alternative minimum tax.

This amendment already has been adopted by the Finance Committee. This amendment affects the 1979 tax forms which were printed prior to the time consideration of H.R. 2797 was scheduled by the

Finance Committee. The Finance Committee adopted the amendment on October 2, 1979, in order that this amendment could be reflected in the 1979 tax forms.

56. Exclusion of foreign taxes as an adjusted itemized deduction for purposes of the alternative minimum tax (sec. 104(a)(4)(E) of the bill and sec. 57(b) of the Code)

The Revenue Act of 1978 added a provision that, for purposes of the computation of the tax preference for "adjusted itemized deductions" for purposes of the alternative minimum tax, deductible State and local taxes, in effect, shall be treated as an "above the line" deduction. No corresponding provision was made in the case of deductible foreign taxes, although the Act provided that the foreign tax credit is allowable against the alternative minimum tax.

The bill would clarify that deductible foreign taxes are treated in the same manner as State and local taxes in computing the tax preference for adjusted itemized deductions.

57. Adjusted itemized deductions of estate or trust and the alternative minimum tax (sec. 104(a)(4)(F) of the bill and sec. 57(b)(2)(A) of the Code)

The Tax Reform Act of 1976 broadened the minimum tax on preferences to include a preference for adjusted itemized deductions. The Revenue Act of 1978 made the preference for adjusted itemized deductions subject to the new alternative minimum tax and clarified the application of the adjusted itemized deduction preference to trusts and estates. Generally, the preference for adjusted itemized deductions is equal to the amount by which itemized deductions exceed 60 percent of adjusted gross income. In the case of estates and trusts, the preference is the amount by which all deductions other than deductions allowable in arriving at adjusted gross income and certain other deductions exceed 60 percent of the estate or trust's adjusted gross income reduced by all deductions. However, under the Act, deductions allowable in arriving at adjusted gross income were subtracted twice.

The bill would modify the computation of the preference for adjusted itemized deductions of a trust or estate to clarify that deductions allowable in arriving at adjusted gross income are taken into account only once.

This amendment already has been adopted by the Finance Committee. This amendment affects the 1979 tax forms which were printed prior to the time consideration of H.R. 2797 was scheduled by the Finance Committee. The Finance Committee adopted the amendment on October 2, 1979, in order that this amendment could be reflected in the 1979 tax forms.

58. Carryover of residential energy credit in connection with alternative minimum tax (sec. 104(a)(4)(G) of the bill and sec. 55(c)(3) of the Code)

The Revenue Act of 1978 imposed a new alternative minimum tax. Generally, credits are not allowed against the alternative minimum tax. However, the Act contained special rules that would allow the carryover of the jobs credit, the work incentive credit, and the investment credit that otherwise would have been lost because of the alternative minimum tax. No comparable rule was provided for the residential energy credit.

The bill would provide a rule similar to the rules applicable to the jobs, work incentive, and investment credits for the residential energy credit that will allow the carryover of the residential energy credit where the taxpayer is subject to the alternative minimum tax.

59. Clarification of the treatment of post-October 1978 capital gains for purposes of the maximum tax (sec. 104(a)(5) of the bill, sec. 1348 of the Code, and sec. 441(b)(2) of the Act)

Prior to the Revenue Act of 1978, the amount of personal service income eligible for the 50 percent maximum tax rate was reduced dollar-for-dollar by an individual's items of tax-preference, including capital gains, for the year. The Act increased the net capital gains deduction from 50 to 60 percent, and provided that post-effective date capital gains would not reduce the amount of personal service income eligible for the 50 percent maximum tax rate. These changes were effective for sales or exchanges after October 31, 1978. However, it was possible that, in certain situations, gains after October 31, 1978, would reduce the amount eligible for the 50 percent maximum tax rate.

In the case of taxable years which begin before November 1, and end after October 31, 1978, the bill would clarify that the amount of personal service income which is eligible for the 50 percent maximum tax rate is to be reduced only by 50 percent of the lesser of: (1) the net capital gain for the taxable year or (2) the net capital gain taking into account only gain or loss properly taken into account for the portion of the taxable year before November 1, 1978.

60. Power of the chief judge of the Tax Court to assign small tax cases to commissioners (sec. 105(a)(1) of the Act and secs. 7456(c) and 7463(g) of the Code)

Prior to the Revenue Act of 1978, an action for a declaratory judgment could, under certain circumstances, be instituted in the United States Tax Court. Such an action could be brought to determine the tax status of an organization, the qualification of certain pension plans, and the tax consequences of certain transfers of property from the United States. Each of the three provisions which conferred declaratory judgment jurisdiction on the Tax Court provided that the chief judge of the Tax Court could assign those proceedings to be heard by commissioners of the Court and could authorize a commissioner to make the decision with respect to such proceedings.

Section 336(a) of the Act provided that an action for declaratory judgment could be brought in the Tax Court to determine the tax status of certain governmental obligations. In order to avoid duplication of provisions in the Code, the Act repealed the separate provisions which allowed the chief judge of the Tax Court to assign commissioners to hear declaratory judgment proceedings and enter decisions in such proceedings. In place of these provisions, the Act added a single provision relating to the power of the chief judge to assign to commissioners proceedings brought under various provisions of the Code.

The Act also provided that tax controversies involving disputes of less than $5,000 could be tried as small tax cases. That provision also provided that the chief judge could assign these proceedings to be heard by commissioners.

In order to avoid duplication in the provisions of the Code, the bill would repeal the specific provision granting the chief judge the power to assign small tax cases to be heard by commissioners. In place of this provision, the bill would add "small tax cases" to the types of proceedings the chief judge may assign to be heard by commissioners.

61. Refund adjustments for amounts held under claim of right (sec. 105(a)(2) of the bill and sec. 6411(d)(2) of the Code)

If a taxpayer receives income under a claim of right and restores it in a later year, he may, under a special method for computing his tax liability, be treated as having made an overpayment of tax on the last day prescribed by law for payment of tax for the year the income is restored. The Revenue Act of 1978 establishes a procedure for a quick refund of the overpayment.

The bill would clarify the time within which the Treasury Department ordinarily must act on the taxpayer's refund application. It also would clarify the extent to which the processing of the application is to be similar to the processing of quick refund claims resulting from net operating loss or other carrybacks.

62. Reduction of estate tax value of jointly held property where spouse of decedent materially participated in farm or other business (sec. 105(a)(3)(A) of the bill and sec. 2040(c)(2) of the Code)

The Revenue Act of 1978 contained a provision (Code sec. 2040(c)) which permitted the efforts of a decedent's spouse to be taken into account in determining the amount of jointly held property used in a farm or other business included in the decedent's gross estate. Generally, under this provision, the value of the gross estate could be reduced by the sum of (1) by the adjusted consideration of the surviving spouse and (2) by 2 percent of the excess of the value of the property over the total adjusted consideration provided by both spouses for each year that the decedent's spouse materially participated in the operation of the farm or other business in which the property was used. The adjusted consideration is the consideration furnished by a spouse plus interest computed at 6 percent per year from the date the consideration was furnished until the date of the decedent's death.

Under this formula, it was possible that less than the decedent's adjusted consideration, or the portion of the value attributable to the decedent's adjusted consideration, would be included in the decedent's gross estate where the total appreciation in the property was less than the assumed 6 percent increase in the original consideration.

The bill would correct this result by providing that the special rule would not apply if the sum of the adjusted consideration provided by both spouses equals or exceeds the value of the property on the date of the decedent's death.

63. Distribution from estate prior to 1980 of farm valuation property (sec. 105(a)(5) of the bill and sec. 1040 of the Code)

Under present law, the distribution of property by an estate or trust in satisfaction of a pecuniary bequest is treated as a taxable transaction resulting in the recognition of gain or loss to the estate or trust.

The Revenue Act of 1978 added a provision to clarify that where property is subject to special farm or other business use valuation, the tax will be measured by the difference between the fair market value of the property on the date of distribution (determined without regard to special use valuation) and the fair market value of the property on the date of the decedent's death (also determined without regard to special use valuation). However, the postponement of the carryover basis provisions, until 1980, inadvertently resulted in a postponement of this provision.

The bill would clarify that the provision added by the Act concerning the distribution of special use valuation property in satisfaction of a pecuniary bequest is effective for estates of decedents dying after December 31, 1976.

64. Clarification of tax treatment of cooperative housing corporations where stock is acquired in a tax-free transaction (sec. 105(a)(6) of the bill and sec. 216(b)(6) of the Code)

In general, a tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid to such a corporation to the extent such amounts represent his or her proportionate share of allowable real estate taxes and interest relating to the corporation's land and buildings (Code sec. 216). In general, for a corporation to qualify as a cooperative housing corporation (which can pass through these deductions to tenant stockholders), 80 percent or more of the gross income of the cooperative housing corporation must have been derived from individual tenant-stockholders.

Under the Revenue Act of 1978, if a person who conveys a house, apartment building, or leasehold therein to a cooperative housing corporation acquires stock in the corporation by *purchase or foreclosure*, together with a lease or right to occupy the house or apartment, such person would be treated as a tenant-stockholder for up to three years from the date of acquisition (even if such person were not an individual). The general intent of this provision was to allow corporate promoters to form cooperative housing corporations and to own the shares in such corporations during a reasonable period while the shares were being sold to individuals who would qualify as tenant-stockholders under the general rules of section 216. The requirement that the stock be acquired "by purchase or foreclosure" may well be interpreted as precluding situations where the corporate promoter acquires the stock in a tax-free transaction (such as a transfer to a controlled corporation pursuant to the provisions of Code sec. 351).

The bill would amend the provisions added by the Act to provide that, if an original seller (e.g., a corporate promoter) acquires stock of the cooperative housing corporation either from the corporation or by foreclosure, the original seller shall be treated as a tenant-stockholder for a period not to exceed three years from the date of the acquisition of the stock. However, except in the case of an acquisition of stock of a cooperative housing corporation by foreclosure, this rule only would apply to stock acquired from the cooperative housing corporation which occurs not later than one year after the date on which the apartments or houses (or leaseholds therein) are transferred by the original seller to the corporation.

65. Amendment relating to exclusion of certain cost-sharing payments (sec. 105(a)(7) of the bill and secs. 126 and 1255 of the Code)

The Revenue Act of 1978 provided an exclusion from gross income for all or a portion of certain payments received under a number of Federal and State cost-sharing conservation programs. Under these provisions, no deduction or credit could be claimed with respect to amounts excluded under the Act, and the basis of any property acquired or improved with these payments would not reflect the excluded amounts. Also, under the Act, a special rule was provided for the recapture (that is, treatment as ordinary income rather than capital gains) of excluded amounts if the property, or improvements, purchased with the payments are disposed of before the expiration of 20 years.

Since the provisions of the Act automatically applied to the excludible portion of all cost-sharing payments, there are some circumstances under which a taxpayer could be worse off under this provision than under prior law. Generally, this results from the fact that, under some circumstances, at least some of the payments received under certain of these programs are reimbursements for costs for which a current deduction would otherwise be allowable. Thus, under prior law, a taxpayer would have had a wash (that is, deductions offsetting income) and the recapture rule would not have applied to him. Under the provisions of the Act, such a taxpayer would have the same effect of a wash (by the exclusion of the income and the disallowance of any corresponding deduction) but would be subject to recapture. Also, there are certain other circumstances where, even though the amounts attributable to reimbursement under these cost-sharing programs were not currently deductible, the taxpayer might (by reason of the application of the investment credit, net operating loss limitations, etc.) be better off under prior law than under the exclusion rule.

The bill would provide that the exclusion for cost-sharing payments and the recapture provision do not apply to any portion of any payment which is properly attributable to an amount which is allowable as a deduction for the taxable year in which the amount is paid or incurred. Also, the bill would provide that, if a taxpayer makes an election, the exclusion provision and the recapture provision would not apply to the excludible portion of any government cost-sharing payment. Such an election would be made not later than the due date (including extensions) for filing the taxpayer's income tax return for the taxable year in which the payment was received or accrued.

Also, an amendment is made to the recapture provision (Code sec. 1255) to coordinate this provision with the other recapture provisions which could potentially result in ordinary income from the disposition of property acquired or improved with excluded cost-sharing payments. (These provisions are section 1251 (relating to recapture of amounts in so-called "Excess Deduction Accounts") and section 1252 (relating to recapture of previously deducted soil and water conservation expenses or land clearing expenses).)

66. Computations of adjusted itemized deductions in case of estates and trusts (sec. 107(a)(1)(A) of the bill and sec. 57(b)(2)(C) of the Code)

Under the Revenue Act of 1978, the alternative minimum tax is imposed on the adjusted itemized deductions preference. The charitable contributions deduction is an itemized deduction that normally may result in the adjusted itemized deductions preference. However, the Act provided an exception in the case of certain charitable deductions of trusts and estates. One exception arises where all the unexpired interests in the trust are devoted to religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals (i.e., the purposes described in section 170(c)(2)(B) of the Code). Another exception arises where all of the income interests in the trust are devoted to religious, charitable, etc., purposes (i.e., purposes described in section 170(c)(2)(B) of the Code) and the grantor had a power to revoke the trust at his death. Neither of the two exceptions applies where the interests in the trust are for purposes other than religious, charitable, etc., purposes (i.e., those purposes described in section 170(c)(2)(B) of the Code) but for which a charitable deduction is nonetheless allowable (i.e., those purposes described in sections 170(c)(1),(3),(4), and (5)).

The bill would modify the exceptions so that they apply to all interests in the trust devoted for purposes for which a charitable deduction is allowed to the trust.

67. Estate tax treatment of gifts within 3 years of death (sec. 107(a)(2)(F) of the bill and sec. 2035 of the Code)

Prior to the Tax Reform Act of 1976, the gross estate of a decedent included all gifts made in contemplation of death that occurred less than 3 years before the date of the decedent's death. Under this rule, the Internal Revenue Service required that only gifts in excess of $1,000 need be disclosed in the estate tax return.

The 1976 Act provided that all gifts made within 3 years of the decedent's death are to be included in the gross estate of the decedent, regardless of whether the gift was made with death time motives. However, the 1976 Act contained an exception to this inclusion rule for gifts to which the annual $3,000 gift tax exclusion applied. While somewhat ambiguous, the legislative history could be read to state that this exception resulted in the inclusion of only the excess of the death time value of all gifts made within 3 years of death over $3,000.

The Revenue Act of 1978 clarified the exception so that it applied only to gifts (other than life insurance) which were not required to be included in a gift tax return. Under this rule, the entire amount of the gift (and not just the excess of the value of the gift over $3,000) is includible in the gross estate where the gift is in excess of $3,000. This clarification in rules was made to apply to gifts made after December 31, 1976.

Since the change in the exception was not adopted by the Ways and Means Committee until October, 1977, it is possible that gifts could have been made in excess of $3,000 based upon the assumption that only the excess of the value over $3,000 was included in the gross estate.

The bill would allow executors of decedents to elect with respect to all gifts made in 1977 (other than life insurance) to all donees to include in the decedent's gross estate only the excess of the death time value over $3,000.

B. TECHNICAL AMENDMENTS RELATING TO THE FOREIGN EARNED INCOME ACT OF 1978

1. Use of tax tables by individuals excluding foreign earned income (sec. 108(a)(1)(A) of the bill and sec. 3 of the Code)

Prior to the Tax Reform Act of 1976, certain individuals working abroad were allowed to exclude from gross income up to $20,000 annually ($25,000 in some cases). The Tax Reform Act of 1976 amended this provision so that these individuals were taxed on their other income at the higher rate brackets which would have applied if the excluded earned income were not so excluded (i.e., the exclusion was "off the bottom"). This amendment made the use of tax tables inappropriate for these individuals and, under the Tax Reduction and Simplification Act of 1977, they are not permitted to use the tables.

The Foreign Earned Income Act of 1978 made a number of changes in the foreign earned income exclusion. Among these is a rule that the excluded income is not taken into account in computing the tax on the taxpayer's other income (i.e., the exclusion is "off the top"). Thus, use of the tax tables no longer would be inappropriate.

The bill would permit individuals who exclude foreign earned income to use the tax tables.

This amendment already has been adopted by the Finance Committee. This amendment affects the 1979 tax forms which were printed prior to the time consideration of H.R. 2797 was scheduled by the Finance Committee. The Finance Committee adopted the amendment on October 2, 1979, in order that this amendment could be reflected in the 1979 tax forms.

2. Definition of "earned income" for purposes of deduction for excess foreign living costs (sec. 108(a)(1)(B) of the bill and sec. 913(e) of the Code)

The Foreign Earned Income Act of 1978 established a deduction for excess foreign living costs for Americans working abroad. The aggregate amount deductible under this provision cannot exceed the taxpayer's foreign "earned income." In addition, earned income also is relevant in the calculation of the excess housing costs, one element of the deduction. For purposes of determining earned income under present law, amounts generally are considered received, and thus earned income, in the year in which the taxpayer performed the services to which those amounts relate. However, this rule does not apply to amounts received more than one year after the year in which the services were performed.

First, for purposes of computing the housing element of the deduction, the bill provides that deferred compensation is taken into account in the year it is included in income, not the year in which the services giving rise to the compensation were performed. Second, the bill provides a new recapture rule to deal with situations where a taxpayer

defers compensation from a year in which he claims a deduction under section 913 for excess foreign housing costs (the "performance year") to a year in which he does not have an excess housing cost deduction. This recapture rule only applies where the compensation ("after-received compensation") is deferred for no more than 3 years after the year in which the services are performed.

3. Disallowance of deductions attributable to excluded foreign earned income (sec. 108(a)(1)(D) of the bill and sec. 911(a) of the Code)

Under prior law, an individual who excluded foreign earned income could not claim any deductions, or take a credit for any foreign income taxes, to the extent properly allocable to, or chargeable against, the excluded income. This provision was carried over under the Foreign Earned Income Act of 1978, but the wording was changed in a way which makes it less clear that deductions, as well as foreign tax credits, allocable to excluded foreign earned income are to be disallowed.

The bill would change the wording to clarify that deductions attributable to excluded amounts will continue to be disallowed.

4. Definition of "qualified home leave expenses" for purposes of the deduction for excess foreign living costs (sec. 108(a)(1)(F) of the bill and sec. 913(g) of the Code)

The 1978 Foreign Earned Income Act allows certain Americans working abroad to deduct reasonable costs of transportation of the individual, his spouse, and dependents from his tax home (generally, his principal place of work) outside the United States to (i) his present (or if none, most recent) principal residence in the United States or (ii), if the preceding rule does not apply to the individual, to the nearest U.S. port of entry (excluding Alaska and Hawaii).

It is not clear how this limitation applies to departures from locations other than the individual's foreign tax home. Also, it is not clear that a taxpayer could ever take a deduction for the cost of round-trip transportation to Alaska or Hawaii.

The bill would make it clear that the taxpayer may deduct the cost of home-leave transportation from a point other than his tax home abroad, but that his deduction will be limited to the lesser of the cost of transportation from (a) his tax home, or (b) the other point abroad from which he departs to (i) his present (or, if none, most recent) U.S. residence, if he actually goes there, or (ii) the nearest U.S. port of entry, if he does not. The nearest port of entry would generally exclude Alaska and Hawaii. However, an individual could elect not to have that exclusion apply, thus permitting deduction of the cost of round-trip travel to Alaska or Hawaii, if nearer than the nearest port of entry in the other states.

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C. TECHNICAL AMENDMENTS RELATING TO THE ENERGY TAX ACT OF 1978

1. Repayment of tax on gasoline used in commercial fishing vessels (sec. 108(c)(1) of the bill and sec. 6421(d)(2) of the Code)

Prior to the Energy Tax Act of 1978, a direct refund of 2 cents a gallon was permitted for the excise tax on gasoline, 2 or 4 cents a gallon for the excise tax on diesel fuels, and the special motor fuels, and 6 cents a gallon for the excise tax on lubricating oil used for certain nonhighway uses. The Energy Tax Act of 1978 removed the direct refund provisions where the products were not used in a trade or business but did not affect provisions allowing the tax-free purchase or indirect credits or refunds for these items where the items are to be used on a commercial fishing vessel. However, the tax-free purchase (or indirect credit or refund) often cannot be obtained because the producer is not selling directly to the operator of a commercial fishing vessel or the final seller does not want to go through the paperwork to obtain the credit or refund.

The bill would allow the 2-cent and 6-cent direct refunds permitted under prior law where the item is used on a commercial fishing vessel.

This amendment already has been adopted by the Finance Committee. This amendment affects the 1979 tax forms which were printed prior to the time consideration of H.R. 2797 was scheduled by the Finance Committee. The Finance Committee adopted the amendment on October 2, 1979, in order that this amendment could be reflected in the 1979 tax forms.

2. Technical corrections with respect to fuels tax exemption for gasohol (sec. 108(c)(2) of the bill and secs. 4081(c) and 6416(b)(2) of the Code)

Under the Energy Tax Act of 1978, gasohol (i.e., fuel which is a blend of gasoline, or other motor fuel, and alcohol) that is at least 10 percent alcohol (other than alcohol derived from petroleum, natural gas, or coal) is exempted from the Federal excise taxes on motor fuels on or after January 1, 1979, and before October 1, 1984. The Act provides that gasoline may be sold free of tax if it is to be used in the production of gasohol. Since motor fuels other than gasoline are taxed on the retail sale or use, a similar tax-free provision is not necessary in such cases. The Act also provides that, if the gasohol for which an exemption from the tax is obtained is later separated into gasoline and alcohol, the person doing such separation is to be treated as the producer of the gasoline (and thus would ordinarily be liable for the 4-cents-a-gallon tax). No provision is made for refund of the tax on gasoline if tax-paid gasoline is mixed with alcohol to produce gasohol.

The bill makes two technical changes. First, the bill amends the provision of present law which allows a refund for tax-paid fuel used for

certain exempt purposes by treating as an overpayment of tax any fuel excise tax paid on gasoline used or sold for use in the production of gasohol. This provision ensures that gasohol can be produced free of any ultimate tax burden (through a credit or refund approach) even though excise taxes had been paid on the gasoline by the producer or importer. Second, the bill amends the provision (Code sec. 4081(c)) which treats a person who separates an exempted gasoline-alcohol mixture into gasoline and alcohol as the producer of such gasoline (and therefore subject to the 4-cents-a-gallon tax) by providing that this treatment applies not only if the gasoline was originally acquired free of tax but also if a credit or refund of excise taxes had been obtained.

3. Tires used in the manufacture of buses (sec. 108(c)(3) of the bill and secs. 4071(e), 6416(b)(3)(C), and 6416(b)(4)(B) of the Code)

Prior to the Energy Tax Act of 1978, a 10-percent manufacturers excise tax was imposed on the sale of buses having a gross vehicle weight of more than 10,000 pounds, with certain exceptions (Code sec. 4061(a)). Another provision (Code sec. 4071) imposes excise taxes on tires, inner tubes, and tread rubber. These taxes generally apply to tires and inner tubes used on buses (as well as other tires, inner tubes, and tread rubber).

The Energy Tax Act repealed the excise tax on buses. In the case of excise taxes on highway tires, inner tubes, and tread rubber, the Energy Tax Act also provided an exemption for sales by a manufacturer, producer, or importer of such items "sold for use" by the purchaser on or in connection with an intercity, local, or school bus. Tires and inner tubes also may be purchased tax free by a vehicle manufacturer to be placed on a chassis which is to be sold (among other things) to a State or local government or a private nonprofit school. If purchased tax-paid and then so used, a credit or refund of tax is available to the vehicle manufacturer. However, if a manufacturer purchases tires or inner tubes to be placed on a bus which is for domestic use by other than a State or local government or by a nonprofit school, the excise taxes on tires and inner tubes are imposed, and there is no provision for credit or refund of such taxes.

The bill provides that if tires or inner tubes are sold on a tax-paid basis to a manufacturer of bus chasis or bodies, the tire tax is to be credited or refunded to the bus manufacturer upon the sale of the bus chassis or body.

4. Refund of tax on lubricating oil used in producing rerefined oil (sec. 108(c)(4) of the bill and sec. 6416(b)(2) of the Code)

Under present law, a 6-cent-per-gallon manufacturers excise tax is imposed on lubricating oil (other than cutting oils) sold in the U.S. by a manufacturer or producer, or used by a manufacturer or producer. The sale of recycled oil is not subject to the tax. However, the excise tax is imposed on the new lubricating oil mixed with the used oil.

The Energy Tax Act of 1978 exempted the sale of new lubricating oil from the excise tax where the oil is sold for use in a blend with previously used or waste lubricating oil which has been cleaned, renovated, or rerefined. Such a blend is designated as "rerefined oil."

The exemption applies if the blend contains 25 percent or more of waste oil. All of the new oil in a mixture is exempt from the tax if the blend contains 55 percent or less of new oil. If it contains more than 55 percent new oil, the exemption applies only to so much of the new oil as does not exceed 55 percent of the blend. However, no provision was made for refunds of the excise tax where tax-paid new oil is mixed with waste oil.

The bill provides for credit or refund of tax paid with respect to new oil in rerefined oil to the extent that the blend of new and waste oil would be exempt from the manufacturers excise tax. As a result, refunds will be available for the tax paid on up to 55 percent of a blend of new and waste lubricating oil which contains at least 25 percent of waste oil. However, refunds would not be available until the blend is used or sold.

5. Credit or refund of tax on truck bodies or chassis used in the manufacture of buses (sec. 108(c)(5) of the bill and sec. 6416(b)(3) of the Code)

Prior to the Energy Tax Act of 1978, a 10-percent manufacturers excise tax was imposed on the sale of buses or trucks having a gross vehicle weight of more than 10,000 pounds with certain exceptions (Code sec. 4061(a)). The Energy Tax Act repealed the excise tax on buses (but not the excise tax on trucks). However, no provision was made for a credit or refund of tax in situations where a person produces a bus from a truck body or chassis (on which tax has been paid) to a bus.

The bill would permit the producer of the bus to obtain a credit or refund of the tax on the truck chassis or body.

III. REVENUE EFFECT

It is estimated that the provisions contained in the bill ("Technical Corrections Act of 1979", H.R. 2797) will not have any overall revenue impact. It should be noted that certain individual provisions may appear to result in a minor revenue increase or decrease. However, the revenue effects which were included in the various acts took into account the basic Congressional policy contained in the revisions made by this bill.

Senator BYRD. The subcommittee will come to order.

I might say that this is the first time in 3 years that the chairman of this subcommittee has not opened the hearing precisely on time. The hearing would have begun precisely on the hour today except I have been meeting with Vice President Mondale and with Secretary of State Vance on the problems in Iran.

The hearings today will deal with the Technical Corrections Act of 1979.

The purpose of the act is to improve and perfect tax legislation enacted by the Congress made in 1978 but which were, for various reasons, improperly implemented in the Revenue Act of 1978, the 1978 Energy Tax Act, and the Foreign Earned Income Act of 1978.

The technical corrections process is, I believe, a good idea. Without it, obvious errors would remain in the tax code for many years creating confusion, complexity, and uncertainty. An important part of the technical corrections process is it gives public witnesses adequate opportunity to review and comment upon proposed technical changes.

The bill as passed by the House corrects many such errors, and it is my understanding that the Department of the Treasury will today submit to the committee additional changes which have been developed through a cooperative process of review and discussion by the Department of the Treasury and the staffs of the Joint Committee and the Committee on Finance.

Now, in connection with the House bill, this committee is prepared to act on the House proposals. If the Treasury or if the staffs of the two committees present large numbers of amendments to the House passed bill, then the committee is not prepared to act on those at this time. To those who are interested in having the technical corrections bill approved, the committee is in a position to act expeditiously on the bill referred to the committee, provided the committee is not given large numbers of amendments to consider by the Department of the Treasury or others.

As I mentioned earlier, an important part of the technical corrections process is to give public witnesses adequate opportunity to review and comment upon proposed technical changes. I propose as chairman of this subcommittee, to give adequate opportunity to the public to comment on any additional changes that might be submitted to the committee today which are not a part of the House bill.

I also understand that public witnesses will be making additional technical proposals to the committee today. I want to stress to these witnesses that the hearings are designed to review technical, and I underscore technical, additions to the bill. I would request that witnesses confine their comments to proposals which they feel will implement prior policy decisions which have already been determined by the Congress. I want to emphasize to the public witnesses which the committee has indicated a willingness to hear today, that we have included the witnesses on the assumption that what the witnesses propose are in fact technical corrections.

A committee pamphlet describing the House technical corrections bill shall be included as part of the printed record of full hearings along with a description of each of the staff and Treasury proposals.

Now as to proposals which are not technical in nature, I would suggest to the witnesses that they present them in the form of a bill which is introduced by a Senate sponsor; in that manner the proposals can be considered in due course in the legislative process.

In addition to review of the technical corrections bill the committee will also hear witnesses on S. 1549 dealing with the excise tax on fishing tackle. Testimony on S. 873 has been invited, but we understand that witnesses on the subject have chosen to submit written rather than oral statements. S. 873 deals with a waiver of residency requirements with regard to the taxation of Americans living abroad.

Now the first witness was to be the distinguished Senator from the State of Florida. Mr. Stone is involved in the meeting which I just left with the Vice President and the Secretary of State. With that in mind, the Chair will now call on Mr. Bradford L. Ferguson, Associate Tax Legislative Counsel, Department of the Treasury.

Mr. Ferguson had been notified that the meeting would be delayed, he is not here at the moment.

The committee is pleased now to recognize Mr. Lipman Redman of the tax section of the American Bar Association.

Mr. Redman is not here at the moment. I might say it is the Chair's fault because I had asked the staff to notify the witnesses that I would not be able to get here until 3 o'clock. Now we have a panel of three, Mr. Thomas W. Power, Mr. Converse Murdoch and Mr. Daniel L. Kiley. Are those three present?

Mr. MURDOCH. Converse Murdoch here.

Senator BYRD. Welcome, Mr. Murdoch.

The Chair is particularly pleased to welcome Mr. Wilbur Mills. I believe it is the first time we have had the privilege to have you appear before this subcommittee, Mr. Chairman. We are very pleased to have you.

Mr. MILLS. Thank you, sir.

Senator BYRD. Would you like to proceed first?

Mr. MILLS. Senator, I am here accompanying Mr. Kiley who will make the statement, one of the panelists. I have no statement. Thank you, sir.

STATEMENT OF DANIEL L. KILEY, VICE PRESIDENT, TAXATION, NORFOLK & WESTERN RAILWAY CO.

Mr. KILEY. Mr. Chairman, I have submitted and would like to summarize my statement.

My testimony today relates to a technical matter regarding clarification of section 369 of the Revenue Act of 1978 which amended section 374 to state the intent of Congress in enacting that section as it applies to consolidated returns. It does not suggest a change in existing tax policy. Present House bill 2797 includes an amendment to the 1978 amendment at section 103(a)(11).

Congress enacted section 374, recognizing that under the provisions of the Regional Rail Reorganization, the so-called 3R, act, the tax treatment upon conveyances to ConRail should be deferred pending the determination of value to be made by a special court created by that act to establish the constitutional minimum value of the conveyed properties. Events now require further clarification of section 374 now be considered. On audit of the Norfolk & West-

ern Railway Co. consolidated tax return for 1976 the Internal Revenue Service has taken the position that section 374 provides nonrecognition treatment only to direct transferors of property to ConRail. This limitation by interpretation produces a problem for us because of our 100 percent controlled stock of Erie-Lackawanna Railway, one of the transferors of property on April 1, 1976. Erie-Lackawanna entered bankruptcy proceedings in 1972, and is currently in the process of reorganization. It is included in our consolidated group for Federal income tax purposes.

Notwithstanding the intent of Congress to defer tax conseqences pending the final determination of value, the Internal Revenue Service has taken a position with respect to this taxpayer that the final value to be awarded by the special court can now be predicted and that a determination can be made by the revenue agents that the stock of EL is worthless. This assertion of worthlessness hinges on a finding by the revenue agents that the amount ultimately to be awarded by the special court to EL will be insufficient to provide value for the EL stock. This position has been taken notwithstanding the fact that the trustees in bankruptcy of EL are seeking a recovery in an amount clearly sufficient to pay off debt and provide value for the stock and this claim is now pending before the special court.

In response to a technical advice request submitted to the National Office of the Internal Revenue Service, the Service has concluded that 374(c) is inapplicable and that the committee reports do not contain anything directly inconsistent with their position. The consequences of this action are to trigger an excess loss account with respect to EL and to effectively eliminate the transferor of rail properties—EL—from the consolidated tax return of its parent—NW.

To rectify this situation, we respectfully request that this committee act to clarify the congressional intent and provide that determination of worthlessness of the stock of a transferor railroad as defined in section 374 may not be made for purposes of the consolidated return regulations where such determination depends on a finding of the final value by the special court.

We acknowledge that the excess loss recapture regulations apply and agree that the legislation should preclude any action by the stockholder subsequent to 1976 which would have the effect of preventing the triggering of the excess loss account. We recognize that tax on the excess loss will be collected no later than the year the EL will be removed from the NW consolidated return.

That recapture may occur as a result of several different events, including the presently proposed reorganization plan, effective January 1, 1981, for EL which would provide for loss of 80 percent stock control of EL by NW. Further, the excess loss account could be triggered prior to the special court determination by other events such as a sale or disposition by NW of the EL stock or a reduction by the trustees of the EL claim in the special court below an amount which would give value to the stock.

We agree that the consolidated return regulations apply to cause a recapture in any of these situations which may occur before a special court determination has been made. However, recapture of the excess loss account which depends entirely upon a finding by

the Internal Revenue Service that EL stock is worthless in 1976 based upon a determination by the Revenue Agents of the final value ultimately to be decided by the special court under the 3R Act is premature until such determination becomes final.

I would like to advise the committee that the proposed clarification of section 374 as outlined in my testimony has been discussed with Treasury and conforms to its requirements. This is outlined in a letter from the Deputy Assistant Secretary, dated October 31, 1979, which I would like to have included as part of my testimony.

This clarification of section 347 will also protect the IRS in that the stockholder would be precluded—subsequent to the running of the statute of limitations—from claiming that the excess loss account was triggered in 1976.

There is no revenue loss involved in the proposed amendment. Rather, it clarifies the year in which such tax is payable under existing law and regulations.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, Mr. Kiley.

Treasury is familiar with your proposal, I assume.

Mr. KILEY. Yes, sir.

Senator BYRD. I would like to get the Treasury's view on that later in the hearing. We will query the Treasury on it. Thank you.

Mr. KILEY. Thank you.

Mr. Chairman, will this letter be accepted for the record?

Senator BYRD. Yes; the letter will be placed in the record.

[The prepared statement and letter of Mr. Kiley follow:]

STATEMENT OF DANIEL L. KILEY, VICE PRESIDENT-TAXATION, NORFOLK & WESTERN RAILWAY CO., ROANOKE, VA.

H.R. 2797, in dealing with needed technical corrections, should address a problem which has arisen in the interpretation of Section 374 of the Internal Revenue Code which covers the tax treatment of exchanges under the Final System Plan for Conrail. Section 374 provides that no gain or loss is recognized when, in order to carry out the Final System Plan, rail properties of a transferor railroad are transferred to Conrail.

The aim of H.R. 2797 is to cure oversights and to clarify and conform various provisions in major tax bills enacted last year, including the Revenue Act of 1978. Section 369 of the 1978 Act amended Section 374 to clarify the intent of Congress in enacting that section in 1976. H.R. 2797 includes a clerical amendment to the 1978 amendment (Section 103(a)(11)).

In both 1976 and 1978 Congress recognized that under the provisions of the Regional Rail Reorganization (3R) Act, the tax treatment upon conveyances to Conrail should be deferred pending the determination of value to be made by a Special Court created by the 3R Act to establish the value. That legislation provided that payment was to be made for the "constitutional minimum value" of the conveyed properties as determined in proceedings before the Special Court with appeal to the Court of Claims under the Tucker Act. Enactment of Section 374(c) in 1976 established rules for the tax consequences resulting from the deferral of the determination of the final consideration for properties transferred under the 3R Act. Section 374 also provides for preservation of net operating losses pending final determination of amounts to be awarded under the plan.

Legislative history is replete with indications that the intent was to defer the tax consequences of the Conrail transfers until after the determination of value. For example, the Committee Reports (H.R. Rep. 94-940) make it clear that no allocation of basis for the securities received may be made until the Special Court determination is final and direct that the Treasury issue regulations on such allocation only after that determination. The special rule that net operating losses of a transferor company are kept available until such time as the compensation is determined (Section 374(e)) recognizes that the Special Court decision could result in an award in excess of the tax basis of the transferred assets, thus producing gain.

Subsequent events require that further clarification of Section 374 now be considered. On audit of the Norfolk and Western Railway Company (NW) consolidated tax return for 1976 the Internal Revenue Service has taken the position that Section 374 provides nonrecognition treatment only to direct transferors of property to Conrail. This limitation produces a problem for NW because of its control of Erie Lackawanna Railway Company (EL), one of the transferors of property to Conrail. El entered bankruptcy proceedings in 1972, and is currently in the process of reorganization. It is included in the NW affiliated group for federal income tax purposes.

Notwithstanding the intent of Congress to defer tax consequences pending the final determination of value, the Internal Revenue Service has taken a position with respect to this taxpayer that the final value to be awarded by the Special Court can now be predicted and that a determination can be made by the Revenue Agents that the stock of EL is worthless. This assertion of worthlessness hinges on a finding by the Revenue Agents that the amount ultimately to be awarded by the Special Court to EL will be insufficient to provide value for the EL stock. This position has been taken notwithstanding the fact that the Trustees in Bankruptcy of EL are seeking a recovery in an amount clearly sufficient to pay off debt and provide value for the stock and this claim is now pending before the Special Court.

In response to a Technical Advice Request submitted to the National Office of the Internal Revenue Service, the Service has concluded that 374(c) is inapplicable and that the Committee Reports (H.R. Rep. 94-940) do not contain anything directly inconsistent with their position. The consequences of this action are to trigger an excess loss account with respect to EL and to effectively eliminate the transferor of rail properties (EL) from the consolidated tax return of its parent (NW).

To rectify this situation, we respectfully request that this committee act to clarify the Congressional intent and provide that determination of worthlessness of the stock of a transferor railroad as defined in Section 374 may not be made for purposes of the consolidated return regulations where such determination depends on a finding of the final value by the Special Court.

We acknowledge that the excess loss recapture regulations apply and agree that the legislation should preclude any action by the stockholder subsequent to 1976 which would have the effect of preventing the triggering of the excess loss account. We recognize that tax on the excess loss will be collected no later than the year the EL will be removed from the NW consolidated return. That recapture may occur as a result of several different events, including the presently proposed reorganization plan, effective January 1, 1981, for EL which would provide for loss of 80 percent stock control of EL by NW. Further, the excess loss account could be triggered prior to the Special Court determination by other events such as a sale or disposition by NW of the EL stock or a reduction by the Trustees of the EL claim in the Special Court below an amount which would give value to the stock. We agree that the consolidated return regulations apply to cause a recapture in any of these situations which may occur before a Special Court determination has been made. However, recapture of the excess loss account which depends entirely upon a finding by the Internal Revenue Service that EL stock is worthless in 1976 based upon a determination by the Revenue Agents of the final value ultimately to be decided by the Special Court under the 3R Act is premature until such determination becomes final.

To clarify this situation, we recommend that this committee act to clarify its intent in enacting Section 374 and provide: That (a) subsection (c) of section 374 of the Internal Revenue Code of 1954 (relating to exchanges under the final system plan for ConRail) is amended by redesignating paragraph (5) as paragraph (6) and by inserting after paragraph (4) the following new paragraph:

"(5) *Coordination with consolidated return regulations.*—For purposes of the consolidated return regulations prescribed under section 1502, if the worthlessness of stock in a transferor railroad depends on a determination of final value by the special court under the Regional Rail Reorganization Act of 1973, such stock shall not be treated as worthless before the date on which such determination becomes final."

(b) The amendment made by subsection (a) shall apply to taxable years ending after March 31, 1976.

DEPARTMENT OF THE TREASURY,
Washington, D.C., October 31, 1979.

DANIEL L. KILEY,
Vice President—Taxation, Norfolk & Western Railway Co.,
Roanoke, Va.

DEAR MR. KILEY: This is in response to your presentations regarding possible statutory changes to clarify the treatment of the excess loss account of the Norfolk and Western Railway in its holdings of the Erie Lackawanna Railway. At present, the Erie Lackawanna is involved in a reorganization proceeding under the Bankruptcy Act. Its financial position depends on the finding of the special court regarding the value of assets transferred by the Erie Lackawanna to Conrail in 1976.

The IRS has taken the position that Norfolk and Western's stock holdings in Erie Lackawanna became worthless in 1976, thus triggering the excess loss account of Norfolk and Western in the Erie Lackawanna. It is apparently conceded that, if the full claim of the Erie Lackawanna were accepted in the Conrail proceeding, the stock of the Erie Lackawanna would have value. However, the IRS has concluded that the Erie Lackawanna could not reasonably be expected to recover enough in the Conrail proceeding to make it solvent as of 1976. At present, it is not expected that a final decision in the Conrail valuation proceeding will be made for a number of years.

While the precise issue raised by the IRS in respect of Norfolk and Western's 1976 tax return is not the same as the issue raised in the Conrail valuation proceeding, we agree with you that many of the same issues would arise in both proceedings, and very likely before the same court. Accordingly, we would not oppose legislation that would effectively hold in suspense the 1976 determination in respect of Norfolk and Western's tax return until the Conrail valuation proceeding becomes final. However, it seems to us that if ultimately the amount received in the Conrail proceeding were insufficient to give value to the stock that it would be more logical for the excess loss account to be triggered as of 1976. We recognize that if you wish to contest the IRS determination at this time, you may prefer no legislation at all to the type of legislation suggested by the prior sentence.

Implicit in our conclusions above is the belief that a finding could be made that Norfolk and Western's excess loss account had been triggered in 1976. Since the Conrail valuation proceeding, as we understand it, is intended to value the Erie Lackawanna assets as of 1976, the conclusion reached in that proceeding could imply that the stock in the Erie Lackawanna was worthless as of 1976. We do not believe that the rules determining when stock is considered worthless require that there be no possible means of obtaining any value from the stock, as long as a reasonable valuation of the stock at the time suggests that the stock then has no value. Accordingly, we believe that a tax could finally be determined to have been due in 1976, in which case interest would run from that time.

In any event, any legislation must not put the IRS in a position that it cannot collect the tax on the excess loss account in any year. Accordingly, we would like to be sure that any legislation makes clear that the tax on the excess loss account shall be collected no later than the year the Erie Lackawanna is removed from the Norfolk and Western consolidated return. Further, we believe that any legislation should preclude any action subsequent to 1976 which would have the effect preventing the triggering of the excess loss account.

Sincerely,

DANIEL I. HALPERIN,
Deputy Assistant Secretary.

Senator BYRD. Our next panelist is Mr. Converse Murdoch of the Small Business Council of America. Welcome to the committee.

STATEMENT OF CONVERSE MURDOCH, ESQ., SMALL BUSINESS COUNCIL OF AMERICA

Mr. MURDOCH. Thank you, Senator Byrd.

I am here today as the president of the Small Business Council of America. This statement is submitted in connection with the subcommittee's consideration of the parts of the corrections bill having to do with section 366 of the 1978 act. Section 366 in the 1978 act was put into the act very late in the session with no opportunity for this committee to hold hearings about it. We believe there are

many technical problems with section 366, only a few of which have been touched on in the technical corrections bill.

The first technical problem has to do with the effective date. The statute as originally enacted in 1978 provided that the new rules about medical expense reimbursement plans will be applicable to taxable years beginning after December 31, 1979.

The committee report on the 1978 act said that the new rules would be applicable to medical expenses reimbursed after December 31, 1979. I don't believe the act itself said that. The act said that if there is a medical plan which is on a fiscal year basis ending January 31, 1980, then employer paid expenses after February 1, 1979—in other words, 10 months ago—are subject to the new act and may be subject to withholding. Small business people particularly are unaware of this provision even at this late date. Many of them are unaware of it, and there is considerable confusion about this effective date. The technical corrections bill which is now before the subcommittee changes the effective date to say it is applicable to amounts claimed and reimbursed after December 31, 1979.

Senator BYRD. May I interrupt you at that point?

Mr. MURDOCH. Yes.

Senator BYRD. Are you objecting to the change that is being made by the technical corrections bill itself, is that it?

Mr. MURDOCH. I believe the change that is being made is to the good. It is contrary to what the committee report said. My point is not that the technical corrections bill is wrong in what it is proposing to do. My point is that it is adding to the confusion which exists in the minds of small business people who are not aware of this and what their duty is right this minute on withholding.

Senator BYRD. Then what you are saying in effect is that the technical correction needs to be corrected itself, is that it?

Mr. MURDOCH. No, sir. My point is that this is the right move—what the technical corrections bill is doing. However, it is only one of many very important technical problems which are posed by this section and which require much more study. It is for that reason that our organization is urging that the technical corrections bill defer the effective date of section 366 generally until this and other technical problems which I can mention are taken care of.

My point really is that there was confusion because of the speed with which this legislation was enacted and it is unfortunate that this and other technical problems are not going to be solved in time to save these plans.

Senator BYRD. Let me ask you this. What you are seeking then is to defer the effective date of section 366 of the 1978 act?

Mr. MURDOCH. That is correct, Senator. We would prefer that the section be repealed but if that is not possible, and I understand that is outside the scope of these hearings, that its effective date be deferred until the technical problems that are in this bill and the technical problems which are not even touched in the pending bill are taken care of. This is not a situation where one taxpayer may be put to some inconvenience. This is a provision that literally affects hundreds of thousands of employers and employees. If there is confusion on January 1 about the technical parts of this bill,

these plans are going to be abandoned. They are not going to be reinstated when the confusion has cleared away.

With the chairman's permission I would like my full statement to be included in the record including the appendix which lists 18 technical problems, some of which are covered in the bill, some of which aren't.

Thank you, sir.

Senator BYRD. The committee will be glad to have your entire statement included in the report. Thank you, Mr. Murdoch.

[The prepared statement of Mr. Murdoch follows:]

PREPARED STATEMENT OF CONVERSE MURDOCH, ESQ.

This statement is submitted in connection with the Subcommittee's consideration of the parts of H.R. 2797 (sometimes hereafter referred to simply as the "bill"), having to do with section 366 of the Revenue Act of 1978 (PL 95-600) (sometimes hereafter referred to as the "Act"), relating to self-insured medical expense reimbursement plans.

This statement is submitted by me on behalf of the Small Business Council of America, Inc.

I am an attorney in private practice in Wilmington, Delaware. Most of the clients of our firm are owners and principals in small businesses—mostly closely held. I am also the President of the Small Business Council of America, Inc.

SUMMARY OF STATEMENT

The following is a summary of my statement.

I urge the Subcommittee to recommend that unless § 366 of the Act (having to do with self-insured medical expense reimbursement plans) is repealed, that it be considerably clarified and its effective date deferred until it can be the subject of full hearings both on the merits of the section and the many technical problems it poses.

The pending bill would amend various provisions of the Internal Revenue Code affected by the enactment of § 366 of the Act. The pertinent parts of the pending bill are §§ 103(a)(10) (A), (B), (C), and (D). These amendments are described at pages 13 and 14 of the Ways and Means Committee report accompanying H.R. 2797, dated June 7, 1979. Report 96-250, 96th Cong. 1st Sess.

BACKGROUND

Prior to the enactment of the Revenue Act of 1978, it had become commonplace for most employers to maintain some sort of a program under which the employer paid all or part of the costs of employees' medical care. These plans did not fall into any clear-cut categories. The variety of these plans were almost literally infinite. The health care needs of particular individuals are so varied that it was a practical impossibility to devise one, two or even ten standard plans which met the particular needs of an individual employee or a group of employees. The size of the employee-group, the age and sex makeup of the group, the geographical location of the group and hundreds of other factors influence the design of employer-sponsored health care plans.

For purposes of certain health care benefit programs, many employers (particularly those in the small business community) found that self-insurance was both feasible and economical.

The growth of these plans was encouraged by the provision in the Internal Revenue Code permitting exclusion of such employer-furnished benefits from the taxable incomes of the benefitted employees.[1] The principal requirement of the Internal Revenue Code prior to the Revenue Act of 1978, with respect to tax qualification of employer-sponsored health care plans was that the plans be for the benefit of employees as opposed to benefitting stockholders. The Internal Revenue Service was successful through litigation in denying income tax exclusions with

[1] See particularly § 105 of the Internal Revenue Code.

respect to plans which were patently discriminatory in favor of the owners of a business, as opposed to the non-owner employees.[2]

These plans flourished in no small part due to the fact that there was a minimum of administrative burden on the sponsoring employer. One has only to look at what happened to many small, qualified pension plans after the imposition of the regulatory burdens imposed by ERISA to appreciate why employers were willing to establish, continue and expand health care programs. In the case of the latter, there was a minimum of "hassle" factor in terms of forms to be completed and filed with the Internal Revenue Service and others.

THE REVENUE ACT OF 1978

Early in 1978, the Administration, as part of its proposals to the Ways and Means Committee, recommended that anti-discrimination rules somewhat similar to those found in the pension and profit sharing plan area be imposed on employer-sponsored health care and other welfare benefit programs.

After hearings on this proposal, the Ways and Means Committee rejected the Administration proposal in this regard. It was generally assumed among the taxpayers familiar with this matter that the rejection of these proposals by the Ways and Means Committee spelled the end of the proposal—at least in connection with the bill which eventually became the Revenue Act of 1978.

However, with no public hearings or prior discussions, at the last minute during consideration of the Revenue Act of 1978, the Senate Finance Committee recommended the enactment of § 366 of the Act. In essence, that section imposed on self-insured medical expense reimbursement plans drastic and novel anti-discrimination rules.

The section, as it cleared the Finance Committee, proposed that any self-insured medical expense reimbursement plan which provided greater benefits for stockholder-employees, officers and highly compensated employees than were provided for other employees would be deemed discriminatory and, as a result, the members of the prohibited group would be required to include in taxable income the excess of benefits received by them over the benefits provided for other employees. It's important to note here the substantial and drastic difference between the anti-discrimination rules of § 366 of the Revenue Act of 1978 and anti-discrimination rules which for years had been applicable in the pension and profit sharing plan area. In the pension and profit plan area, it has long been recognized that a plan is not discriminatory merely because benefits are proportionate to other compensation. However, in § 366 of the 1978 Act, for the first time discrimination was tested in terms of absolute dollars of benefits, rather than in terms of percentage of compensation.

It's also important to note at this point that § 366 of the 1978 Act is limited to self-insured plans. The effect of this is that a self-insured plan which is discriminatory for purposes of that Act can acquire a tax-favored status by the simple device of having an insurance company provide the benefits. The effect of this is merely to cause the employer to incur the extra costs associated with the purchase of insurance. The effect will not be to spread benefits to more employees. The only ones who will profit from this rule will be the insurance companies who can now charge employers a fee for providing benefits which heretofore the employers were able to provide more economically on their own.

As all members of Congress are aware, the Revenue Act of 1978 was passed during the final days of the session. As a result, there was little opportunity for the tax-paying public to become aware of § 366 of the 1978 Act—much less to study it and make comments to members of Congress.

THE TECHNICAL PROBLEMS

Because of the infinite variety of employer-self-insured plans, it's a practical impossibility for anyone at this time to point up all of the technical problems which will be encountered once § 366 of the 1978 Act becomes fully effective. The only way that even a substantial fraction of these problems can be brought to the surface and considered is through hearings on the substantive provisions.

Unless Congress repeals or delays the effective date of § 366 of the Act, these novel rules for self-insured medical expense reimbursement plans will become effective no later than January 1, 1980—less than 55 days from the date of these

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[2] See *Leidy et al*, 34 TCM 1476, 1975 P-H TC Memo ¶ 75, 340 (1975) aff'd per curiam 77-1 USTC ¶ 9144, 39 AFTR 2d 77-877 (4th Cir. 12/16/76); *John H. Kennedy, Inc. et al.*, 36 TCM 878, 1977 P-H TC Memo ¶ 77, 210 (7/11/77) and cases cited there.

hearings. In fact, there's a serious question as to whether the new rules may have already been in effect for many months.

Many persons who will be affected by this new law are, even at this late date, unaware of the changes in the law.

The Internal Revenue Service has not yet published (even in proposed form) regulations about the myriad and novel problems posed by this new law.[3] Even if the Treasury had published proposed regulations today—the new law would become effective (if it isn't already effective) long before there could be meaningful public comment and promulgation of final regulations. There is attached to this statement an appendix listing a sampling of technical problems posed by section 366 of the Act. These are not fanciful problems. They are real. Unless Congress defers the effective date of § 366, hundreds of thousands of affected employers and employees will face decisions as to how to comply with the new law on January 1, 1980 and with no authoritative guidance as to how to proceed. Many employers facing that situation will simply abandon their medical expense reimbursement plans rather than run the risk of guessing wrong on IRS' likely interpretations of this novel legislation.

The ideal solution is for Congress to repeal § 366 of the Act and arrange public hearings to consider appropriate legislation. The next best solution is to defer the effective date until there can be adequate consideration of the many issues posed by this legislation. In the interim, the Treasury can promulgate proposed regulations which this Committee and other Congressional bodies can review.

An indefinite deferral of the effective date would be appropriate. This Subcommittee has already held hearings on S. 224, a bill to indefinitely freeze fringe benefit regulations. In connection with those hearings testimony was received on the matter of tying the deferral of the effective date of § 366 of the Act to the deferral of action on fringe benefit regulations.

The House has recently passed H.R. 5224 freezing fringe benefit regulations until June 1, 1981 to give Congress an opportunity to consider the fringe benefit issues. While repeal of § 366 or indefinite deferral of its effective date are preferable, our organization believes that a deferral of the effective date until June 1, 1981 (i.e., the end of the fringe benefit regulation freeze as set forth in H.E. 5224) would be of considerable help. That would at least give Congress some opportunity to consider the technical problems posed by § 366.

Such deferral would also permit Congress to consider self-insured medical expense reimbursement plans in connection with the closely related but much large problems of national health insurance, catastrophic medical expense programs (presently being considered by the Finance Committee) and the bill recently introduced by Chairman Ullman to place a cap on deductible employer-paid employee health insurance—to mention only a few. All of these proposals are so serious and the tie-ins between them and self-insured medical expense reimbursement plans are so patent—all should be considered together before permitting § 366 of the 1978 Act to become effective.

THE EFFECTIVE DATE OF SECTION 366 OF THE 1978 ACT

The Joint Committee Staff Summary of the pending bill (§ 44 of the Summary) points up the effective date problems associated with the enactment of section 366.

The only "sanction" on plans not complying with the rules imposed by section 366 of the Act is with respect to the benefitted employees. No attempt is made to disallow employer deductions not to impose a tax on the plan itself.

The section, as originally enacted, provided that it was applicable to taxable years beginning after December 31, 1979. However, the section, itself, provided that an affected employee was to pick up income under the section during the employee's taxable year with which or in which the plan year ended. Thus, if an employer had a plan year ending January 31—benefits paid on or after February 1, 1979 could have been the subject of the section because the benefit was to be reported as income in the employee's taxable year 1980—i.e., the employee's year in which the plan year ended.

The Conference Committee Report on the 1978 Act, in discussing the effective date provision, stated: "* * * The Conference agreement applies to claims filed and paid in taxable years beginning after December 31, 1979."

The now-pending bill proposes to change this effective date to read as follows: "The amendment made by this section [§ 366 of the 1978 Act] shall apply to amounts reimbursed after December 31, 1979." This history of the effective date provision (i.e., as per the originally-enacted section; the Conference Committee

[3] As of November 1, 1979, IRS had assigned this regulations' project to a second priority. See IRS Chief Counsel, Regulations Projects, Status and Disposition Report.

Report on the 1978 Act; and the now-pending bill) will cast considerable doubt on the effective date while the pending bill is before Congress. Thus, employers today will be uncertain as to whether benefits they have paid before January 1, 1980, are, or are not, going to be subjected to the rules of section 366.

TECHNICAL PROBLEMS UNDER SECTION 366 OF THE 1978 ACT

There are myriad technical problems posed by section 366 of the 1978 Act which will remain even after the enactment of the pertinent provisions of the now-pending bill.

Attached to this statement is an Appendix, listing in summary form, a few of the technical problems which have been posed by the enactment of section 366 of the 1978 Act. No claim is made that this list is anything more than the result of scratching the surface of the problems. When Treasury Regulations are proposed and public comment is invited, there will undoubtedly be many other problems which will surface and have to be dealt with.

Until more problems have surfaced and can be dealt with, it is a great unfairness to employees covered by self-insured medical expense reimbursement plans to keep them in doubt as to whether their plan qualifies under section 366.

As long as there is doubt about these matters, the natural reaction of employers will be to drop plans unless and until there is clarification. This would be a most unfortunate development benefitting no one. There would be no applicable revenue effects flowing from such a development. The Joint Committee Staff general explanation of the Revenue Act of 1978 says on this point:

"This provision [§ 366 of the 1978 Act] will have no revenue effect in fiscal year 1979 and will increase budget receipts by *less* than $5,000,000 per year thereafter." [Emphasis supplied].

By way of a sampling of the technical problems which will have to be resolved in regulations, the following can be mentioned:

1. Is it permissible to have a plan under which the employer reimburses employees for premiums for various kinds of health care insurance where the amount of premiums reimbursed varies with the cash compensation of the employees?
2. Does the provision apply to government programs?
3. What benefits are part of the "plan"? For example, assume that an employer maintains what is concededly a non-discriminatory plan and during the last part of a plan year, as an act of compassion for a member of the prohibited group, the employer reimburses him for some catastrophic expense. Does this mean that on a retroactive basis the plan becomes non-qualified?
4. How does one test discrimination in favor of the highest paid 25% of employees when there are less than four employees? Are all of the employees in such a situation in the top 25% or are none of them?

These are real problems. Unless and until they are solved in the Regulations, employers will be given no practical alternative to either incurring the additional cost of paying an insurance company to run the plan or simply abandoning the plan.

PLANS WILL BE TERMINATED RATHER THAN BEING BROUGHT INTO COMPLIANCE WITH THE NEW LAW

It must be assumed that the proponents of section 366 of the 1978 Act believed that its enactment will result in the spreading of benefits to more rank and file employees. Based upon my discussions with literally hundreds of lawyers, accountants, insurance advisers and business men from all parts of the United States, I am firmly convinced that if section 366 becomes effective, it will have exactly the opposite effect. It will result in one or more of the following:

1. Employers will simply abandon self-insured medical expense reimbursement plans.
2. They will continue existing plans with curtailed coverage for rank and file employees and provide added cash compensation for those who bear higher taxes because of the new law.
3. Employers will turn to insurance company plans paying roughly the same benefits and swallow the added (but deductible) cost of using an insurance company product.

I don't know of a single employer which intends to attempt compliance with section 366 of the 1978 Act.

Simple arithmetic can demonstrate why this is so.

Assume an employer-corporation in which the owner is an active employee earning $50,000 per year. Assume that there are ten other employees with average

compensation of $20,000 per year. Next, assume that the employer maintains a medical expense reimbursement plan under which each employee is entitled to reimbursement for up to 5 percent of his compensation. The result is that the owner-executive is entitled to $2,500 of medical expense reimbursements per year and each of the other employees is entitled to an average of $1,000.

To bring the plan into compliance with section 366 of the 1978 Act will require the employer to promise benefits to each employee of up to $2,500 per year—the same as that promised the owner-executive. This means that the employer is exposed to an additional cost for maintainng the medical expense reimbursement plan of $15,000 (an added $1,500 multiplied by 10 employees). An employer with even a rudimentary understanding of arithmetic can quickly note that it is cheaper to either abandon the plan entirely and award a $5,000 bonus to the executive—resulting in after-tax income of $2,500 to pay medical expenses or to keep the existing plan and bonus the executive enough to pay the tax on the excess of his benefits over those supplied to the other employees.

Thus, regardless of how well motivated the legislation was, it will simply not achieve its stated objectives of spreading benefits to more employees. The more likely result is to have small business employees dropping plans and thereby providing less benefits for employees.

When one plugs into this picture the added legal and accounting costs of attempting to understand and comply with the new law, the savings through dropping the old plan become even more dramatic. Particularly is this so when it is realized that it may be years before there are final interpretations of the new law.

A distinguished Cleveland attorney, Dean Hopkins, has aptly described the certain results of letting section 366 of the Revenue Act of 1978 become effective as reminiscent of Walter Lippman's political tragedy titled, "The Murder of a Beautiful Theory By a Gang of Brutal Facts".

THE NEW LAW IS DISCRIMINATORY AGAINST SMALL BUSINESSES

The new law is applicable only to plans not involving insurance company products. Thus, any employer willing and able to spend the money to buy insurance company products to provide benefits can completely avoid the rules of the section.

In my opinion, this legislation will, if it becomes operable, seriously discriminate against the employees of small businesses. Large businesses, with their superior resources and bargaining power, can enter into custom-made contracts with insurance companies providing for medical expense reimbursements for employees which, if not supplied through an insurance company, would be violative of section 366 of the 1978 Revenue Act. Small businesses do not possess the power to enter into such contracts with insurance companies. Accordingly, they opt for the economy and simplicity which goes with self-insured medical expense reimbursement plans.

Big businesses are more likely to have finely drawn employee benefit plans which in many cases are in part dictated by the terms of collective bargaining agreements.

Small business can ill afford the inside or outside legal and accounting help necessary to understand and hope to comply with complex laws. Accordingly, small businesses are more and more finding that they can't cope with the ever-rising ride of federal regulations. The natural result is that more and more small businesses are abandoning fringe benefit programs because they can't afford the "hassle factor". One has only to look at the experiences with abandonment of small company pension plans following the enactment of ERISA to foretell what is going to happen in the small business community if section 366 of the 1978 Revenue Act becomes effective. Employers in the small business community are going to abandon their plans for reimbursing employees for medical expenses.

To say that this law does not discriminate against small business is closely akin to the observation that the French laws against sleeping under bridges, begging in the streets and stealing bread were not discriminatory against the poor because they applied to the rich and poor alike.

As indicated earlier in this statement, the Treasury has still not published any proposed regulations about this new section and it's unlikely that regulations will be available in time for employers to attempt compliance on the effective date. This will add further confusion to the picture and give small businesses another reason to abandon plans rather than go through the uncertainty and expense of adopting new plans and then later amending and reamending them to attempt to bring them into compliance with ever-changing Treasury interpretations of the law. Once plans of this type are abandoned, it's unlikely they will be reinstated when the dust settles several years from now.

CONCLUSION

I respectfully urge that if the Subcommittee is not prepared at this time to recommend the repeal of section 366 of the Revenue Act of 1978, that it at least defer the effective date to give Congress the opportunity to consider the implications of section 366 of the Revenue Act of 1978.

APPENDIX TO STATEMENT OF CONVERSE MURDOCH

SAMPLES OF TECHNICAL PROBLEMS UNDER SECTION 366 OF THE REVENUE ACT OF 1978

1. Will employers be required to submit information returns reporting taxable benefits? The original legislation is silent regarding the employment tax and withholding duties under section 366. The Conference Report says there is no social security tax or withholding associated with the provision. Under section 103(a)(10)(A) of the Technical Corrections Act of 1979, payments excludable under section 105 of the Code will be free of withholding. No mention is there made of social security taxes. As drafted, the provision of the bill says nothing about payments which are not excluded under Code section 105—i.e., benefits made taxable by virtue of section 366 of the 1978 Act.

The Ways and Means Committee report of the pending bill (H.R. 2797) states that withholding will not be required "if it is reasonable to believe that the employee will be allowed to exclude the payment [under the medical benefit plan] from gross income * * *." That statement is difficult to reconcile with the Conference Committee Report on the 1978 Act which flatly stated that payments under plans "would not be subject to withholding tax * * *". It is impossible to reconcile with the Joint Committee Staff description of the pending bill where it is stated (at page 18 of the Staff description): "The bill [H.R. 2797] would clarify present law by continuing the withholding tax exclusion for reimbursements under a self-insured medical reimbursement plan, whether or not the plan is discriminatory [emphasis supplied]."

2. Will government plans for government officers and employees be covered?

3. What will constitute "insurance"? For example, can a single employer or a small group of employers own the insurance company which provides the benefits? What if premiums for "insurance" are tied directly to the benefits paid?

4. In attempting to comply with sex anti-discrimination rules, can an employer end up violating section 366 of the 1978 Act? For example—what if the members of the prohibited group are women and the other employees are men and the plan pays maternity benefits?

5. How will the rules be applied when an employer has an interest in a second (or third) business in another locale where certain medical care benefits are not feasible?

6. How can one determine whether a particular employee is one of the highest paid 25% when there are less than four employees?

7. May the employer reimburse all employees for health care insurance premiums based on levels of compensation? Is such a plan "self-insured"?

8. Will Treasury go along with Conference Committee definitions of part time and seasonal employees?

9. Under a plan which requires three years of service—what breaks in service will require the commencement of a new three year employment period?

10. Does making an employee an officer late in the plan year retroactively disqualify the plan?

11. What is the definition of an "officer"? For example, is a clerical employee designated an Assistant Treasurer solely to enable that person to sign state unemployment tax return forms an "officer"?

12. Will the Treasury agree with (and can it effectively and fairly administer) the suggestion in the Conference Committee Report that plans should not be retroactively disqualified if "the plan has made reasonable efforts to comply with tax discrimination rules"?

13. Will the Treasury agree that section 366 as written permits integration with plans of other employers?

14. How will "plan" be defined in the regulations? Assume a clearly non-discriminatory written plan and late in the year the employer, without amending the plan pays substantial hospital bills for the terminally ill wife of a junior executive. Is such a payment part of the plan and therefore is the whole plan retroactively disqualified?

15. Is the typical Blue Cross or Blue Shield plan insurance? Cf., the Finance Committee report on the 1978 Act where it was stated that insured plans means

those in which benefits are "provided by a licensed insurance company", Sen. Rep. 95-1263, p. 186. What of a plan utilizing a section 501(c)(9) organization (i.e., on exempt employees' beneficiary associations)?

16. How does one apply the part time employee exclusion rule? Assume the same employee works part time for some of the year, but full time during other periods (e.g., 10 hours per week while attending school, but 40 hours per week during school vacation periods)? Does the employee shuttle between being covered and not covered? What if the employee becomes ill during a period of part time service, but incurs reimburaeable expenses while in full time status?

17. Must an employer pay benefits for an employee who is terminated? For an employee on leave of absence? For an employee on terminal leave?

18. Can there be a "plan" which promises nothing but permits the employer at the end of each year to retroactively reimburse for expenses on a non-discriminatory basis after seeing the extent of exposure?

[Note these are but samples of the problems. Every day more problems surface. When the section becomes fully effective, the flood of problems will accelerate.]

SUPPLEMENTAL STATEMENT SUBMITTED BY CONVERSE MURDOCH, ESQ.

On November 7, 1979, I, on behalf of the Small Business Council of America, Inc., submitted a statement to the Subcommittee regarding H.R. 2797 (the Bill).

I appeared as a witness at the hearings on November 7, 1979. At that time I learned for the first time that the Treasury Department had prepared a long statement setting forth additional proposed technical corrections to be included in H.R. 2797. Senator Byrd, who was presiding at the hearing, stated that in view of the fact that the public had not been informed in advance about this supplemental submission by the Treasury, he was going to hold the record open for another two weeks to permit representatives of the public to comment on the Treasury's supplemental submissions.

The purpose of this supplemental statement is to comment on the parts of the supplemental submission of the Treasury having to do with § 366 of the Revenue Act of 1978 (PL 95-600) (the "Act").

THE TREASURY IN ITS SUPPLEMENTAL SUBMISSION PROPOSES TWO ADDITIONAL CHANGES WITH RESPECT TO SECTION 366 OF THE ACT—HAVING TO DO WITH SELF-INSURED MEDICAL EXPENSE REIMBURSEMENT PLANS

The first proposal of the Treasury is to change the Act and the Bill to exclude payments under self-insured medical expense reimbursement plans from withholding whether or not the particular plan complies with the provisions of § 366 of the Act. The second proposal of the Treasury has to do with clarification of the effect of pre-1980 reimbursements on the qualification of the plan for post-1979 periods.

Small Business Council of America, Inc. favors both of the changes suggested in the Treasury's supplemental submission.

The first (i.e., the exemption from withholding) takes care of one of the many technical problems pointed up by the Small Business Council of America, Inc. in its previous submissions to this and other committees. The second supplemental proposal by the Treasury is also approved by the Small Business Council of America, Inc. although the technical problem covered by the second proposal is not one which our organization believes was of substantial import.

THE SUPPLEMENTAL SUBMISSIONS BY THE TREASURY DEMONSTRATE ANEW THE NEED FOR A DEFERRAL OF THE EFFECTIVE DATE OF SECTION 366 OF THE ACT

In the November 7, 1979 submission by Small Business Council of America, Inc. to the Committee, there were a great many technical problems with § 366 of the Act listed there. Eighteen of these technical problems were listed in an Appendix to the original statement. One of the Treasury's supplemental submissions takes care of a part of one of the eighteen technical problems pointed up by our organization.

This development is all to the good. However, the mere fact that the Treasury at this late date has seen fit to make a supplemental proposal to take care of one of eighteen presently known technical problems dramatically demonstrates why the effective date of § 366 of the Act should be postponed.

By virtue of this supplemental submission by the Treasury Department, I'm convinced that if given a reasonable period of time, those concerned with the tax treatment of medical expense reimbursement plans could come up with recommendations to the Committees of Congress, which would minimize the technical problems and hopefully achieve some of the goals of the sponsors of § 366 without sacrificing worthwhile medical expense reimbursement plans.

I believe that open discussions between representatives of the Treasury, the tax writing Committees of Congress and affected employers and employees could lead to worthwhile legislation.

CONCLUSION

Small Business Council of America respectfully urges the Committee to give those concerned with self-insured, medical expense reimbursement plans a fair chance to work on elimination of technical and policy problems associated with the enactment of § 366 of the 1978 Act.

Senator BYRD. Is Mr. Thomas W. Power present?

Mr. POWER. Yes, Mr. Chairman, right here.

Senator BYRD. Are you proposing a technical correction?

Mr. POWER. A technical correction, at least we think as we construe it to be a technical correction. I have a prepared statement but I would like to submit it in full for the record and then just make a brief summary if I may of the statement as submitted.

Senator BYRD. That is satisfactory.

STATEMENT OF THOMAS W. POWER, GENERAL COUNSEL, FOODSERVICE AND LODGING INSTITUTE

Mr. POWER. My name is Thomas Power and I am general counsel of the Foodservice and Lodging Institute, a Washington-based trade industry group of 35 of the Nation's largest multiunit and multi-State food and lodging companies. Collectively, these companies own, operate, or have franchise agreements with more than 38,000 individual establishments, have annual gross sales in excess of $21 billion and employ in excess of 2.5 million persons. This employment figure represents almost 25 percent of the total employment force in the entire restaurant industry.

Let me say at the outset, Mr. Chairman, the targeted jobs tax credit is a good law. It recognizes the problems of acute unemployment within these groups, and it is the first real positive step taken by the Federal Government to enlist business and industry in the massive fight to reduce unemployment within specific hard-to-employ sectors of the population.

We are here today to respectfully request that this committee include in the Technical Corrections Act of 1979 a clarification indicating that 19-year-olds are covered under the work study category in the targeted jobs tax credit.

As we understand it, the proposed Technical Corrections Act of 1979 currently contains four provisions to clarify the targeted jobs tax credit which was enacted by Congress in 1978 as part of the 1978 Revenue Act: (1) Correction of the expiration date of the credit; (2) clarification of the effective date for election of the credit; (3) clarification of the effective date for newly targeted groups under the credit; and (4) clarification of the transitional rule for fiscal year taxpayers claiming the credit.

The Technical Corrections Act should also include a clarification indicating that 19-year-olds in cooperative education programs are covered under the legislation.

As I am sure all of you are aware, one of the targeted groups for which the TJTC can be claimed are 16- to 18-year-old youths who are participants in qualified cooperative education programs. In order to restrict use of this category to students who normally progress through high school, and are developing initial job skills,

the maximum age was established at 18, the traditional age of a high school graduate. Unfortunately, this 16- to 18-year-old grouping does not reflect the normal age makeup of persons in these high school programs.

The 16–19 grouping also more clearly recognizes the demography of the work-study program. It is not in the traditional high school mold. Many students in these programs simply do not graduate from high school at the age of 18 or earlier because of the social, academic, or economic environment in which they have been raised. A typical work-study student is from a low income family. For example, a 1975 survey of post high-school work study students indicated that 77.7 percent of the students were from families with income levels below $12,000 yearly. A 1976 survey in eight Southern States indicated that 65 percent of the high school work study students were from families with income of $10,000 or less. Moreover, many work-study students are dropouts who have been persuaded to return to school. Clarifying the targeted age bracket of students to include 19 will further encourage dropouts to return to school and will encourage employment of these dropouts.

The effectiveness of the targeted jobs credit will be evaluated by both the Government and outside agencies. The Department of Labor uses, and outside agencies widely accept, 16 to 19 as a natural grouping in its analysis of youth employment. Evaluations of the jobs tax credit and ease of administration in the required reporting by the Secretaries of Labor and Treasury would be facilitated by a grouping of 16 to 19 for work study students.

Furthermore, during a recent hearing before the Select Revenue Subcommittee of the House Ways and Means Committee, the U.S. Treasury stated that it does not oppose much a minor adjustment and the revenue cost of this clarification is minimal.

The 16 to 19 grouping more effectively stimulates employment, recognizes the demography of the work study program, would encourage the return to school and employment of dropouts, and is not expensive.

This is a logical clarification and one that will benefit employers and employees alike. We believe that of all seven specific targeted categories, our most reliable and trainable workers come from the work-study group. This is probably because these young men and women have demonstrated their desire to work while continuing their much-needed education. Several companies have pointed out to me that some of these young persons from the work-study category are now entering or have completed management training programs. Several, who started as crew workers and kitchen help, are now assistant managers and will some day manage their own operation.

In summary, Senator, Congress intended to include all students who normally progress through high school and are in work-study programs when it developed this legislation in 1978. A 16- to 19-year-old grouping clarifies this congressional intent by recognizing the unique nature of the work-study student body. At the same time, Congress will be providing thousands more young men and women with improved opportunities to secure meaningful employment.

Thank you.

Senator BYRD. Thank you Mr. Power.

I understand that Senator Stone of Florida is interested in this matter also.

Mr. POWER. That is correct, Senator.

Senator BYRD. If he is not able to be here before the committee adjourns, I will have his testimony made a part of the record.

Mr. POWER. We appreciate that very much. Any support we can get.

Senator BYRD. Thank you, Mr. Power.

Mr. POWER. Thank you very much.

[The prepared statement of Mr. Power follows:]

PREPARED STATEMENT OF THOMAS A. POWER, GENERAL COUNSEL, FOODSERVICE AND LODGING INSTITUTE

Good afternoon, Mr. Chairman and members of the Committee on Finance. My name is Thomas W. Power and I am general counsel of the Foodservice and Lodging Institute, a Washington-based trade industry group of 35 of the nation's largest multi-unit and multi-state food and lodging companies. Collectively, these companies own, operate or have franchise agreements with more than 38,000 individual establishments, have annual gross sales in excess of $21 billion and employ in excess of 2.5 million persons. This employment figure represents almost 25 percent of the total employment force in the entire restaurant industry.

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The Technical Corrections Act should also include a clarification indicating that 19 year olds in cooperative education programs are covered under the legislation.

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In summary, Senator, Congress intended to include all students who normally progress through high school and are in work study programs when it developed this legislation in 1978. A 16 to 19-year-old grouping clarifies this Congressional intent by recognizing the unique nature of the work study student body. At the same time, Congress will be providing thousands more young men and women with improved opportunities to secure meaningful employment.

Senator BYRD. The next witness is Mr. Bradford L. Ferguson, Associate Tax Legislative Counsel, Department of the Treasury.

Welcome, Mr. Ferguson.

STATEMENT OF BRADFORD L. FERGUSON, ASSOCIATE TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Senator BYRD. Incidentally, before you start you heard Mr. Power's testimony here a moment ago, I believe. Do you have any comment on his proposal?

Mr. FERGUSON. I was not here for that statement, Mr. Chairman.

Senator BYRD. All right.

Mr. FERGUSON. Mr. Chairman, I would like to discuss three bills today. The first bill is H.R. 2797, which is the Technical Corrections Act. That bill would provide certain nonsubstantive changes in four revenue acts passed in 1978.

Senator BYRD. Let me be sure I understand what you are testifying on. You are testifying now on the House passed proposal, are you?

Mr. FERGUSON. That is right.

Senator BYRD. Not on additions to that but on the House proposal itself.

Mr. FERGUSON. That is correct, Mr. Chairman. My statement in itself will be devoted to the House bill. Attached to that statement, and now being distributed, is a description of amendments that have been proposed since the House bill was adopted. Those amendments have been reviewed by the Senate Finance Committee staff and Treasury staff in conjunction with the staff of the Joint Committee on Taxation.

Senator BYRD. Now let me see if I understand this. I have something called attachment.

Mr. FERGUSON. Yes.

Senator BYRD. And it is 45 pages. Now are these 45 pages of proposals that you are proposing to the committee today?

Mr. FERGUSON. Those are proposals that have been written up by the Joint Committee staff after consulting with the Senate Finance Committee staff and with us at Treasury. We have no objection to any of those items. We support the package of proposals as technical nonsubstantive amendments to the 1978 legislation.

Senator BYRD. My staff did not get this until yesterday. The public has not had access to it at all.

Mr. FERGUSON. Mr. Chairman, I think a possible benefit from my testimony is to put these proposals before the public prior to the markup session. I recognize that the hearings today will not focus on them. But perhaps through written comments and through other public contacts with staff, we can determine whether there are any problems. As best as we can tell, from the point of view of Treasury staff, these proposals are all technical amendments; and they should be noncontroversial.

Senator BYRD. That is fine. I would assume that is the case but this committee had submitted to it not long ago some legislation which was supposed to be merely a simplification. After review, it was determined that it had a very radical effect on a multitude of individuals. We had to hold the entire piece of legislation because of what purported to be a simplification was indeed a very substantial change, a very dramatic change and a very undesirable change. It had the complete and total opposition, and I think justifiably so, of farm bureaus all over the country. So while I am willing to assume for the time being that these are purely technical changes, we are faced with 45 pages here that you are coming in with today.

What I would propose to do is to put these proposals in the record and make a decision later on whether it is necessary to hold a hearing on it. This committee can proceed right now, and I think the committee is willing to proceed right now, on the technical corrections bill passed by the House. Everyone has had an opportunity to look that over. No one has had an opportunity outside of your staff and the committee staff to know what is in these 45 pages and it is very difficult for the committee today to attempt to digest 45 pages of new amendments of a highly technical nature.

Now, Mr. Ferguson, I wonder if you would mind, Senator Stone was to be the first witness today and he was detained at a meeting that I attended. Senator Stone attended a meeting also with Vice President Mondale and the Secretary of State Vance but Senator Stone is here now, and he does have another committee meeting. If you don't mind I believe I will call on Mr. Stone and then we will come back to your proposals.

Mr. FERGUSON. I am pleased to defer.

Senator BYRD. Thank you.

Senator Stone.

STATEMENT OF HON. RICHARD STONE, A U.S. SENATOR FROM THE STATE OF FLORIDA

Senator STONE. Thank you, Mr. Chairman.

Senator BYRD. I announced earlier that you were tied up in another meeting.

Senator STONE. Thank you, Mr. Chairman, very much. I will be brief because I know the committee is pressed for time.

Mr. Chairman, on behalf of myself and Senators Thurmond, Boren, Hollings, and Bentsen as cosponsors of S. 1861, I am asking that the committee include the substance of that bill in the Technical Corrections Act of 1979.

Briefly, what it does is to add 19-year-olds to the existing program of targeted jobs tax credits for work study students of the 16- through 18-year-old age group. The reason why 19-year-olds should be added as a technical correction, as opposed to a major substantive correction, is that in passing this program a little more than 1 year ago Congress intended to include the group of disadvantaged students which do in fact include 19-year-olds.

Why does it include 19-year-olds? Because this is a socioeconomic group that takes a little longer to finish high school; a lot of them are dropouts who think better of the situation and go back to school. We are really talking about as many as 50 percent of the target group being omitted by reason of this technical limitation to 18-year-olds, when it should have been 19-year-olds.

In testimony regarding a similar bill on the House side the Treasury Department has testified that they will not object to this inclusion because the revenue impact loss is minor, the whole cost per year being less than $5 million. It could add as many as 20,000 targeted jobs. Business and industry is most anxious to work with this 19-year-old group, along with the 16- through 18-year-olds.

This project is actually working. It is helping young people who are most in need of work, the unemployed high school student type of person. By adding a tax credit it gets them into learning business and employment skills.

Instead of losing time at a time when we should act quickly, since the congressional intent was quite clearly to include the actual group of targeted young people which physically and chronologically does include 19-year-olds, we think—those of us to who are cointroducers of this bill—that it probably does belong and easily can be put into the Technical Corrections Act of 1979.

Senator BYRD. Thank you, Senator Stone. Do you happen to know the attitude of the Treasury on this?

Senator STONE. Yes; they do not object, they testified on the House side to a similar bill. I will give you the number, H.R. 3586. In their words they do not oppose this relatively minor change.

Senator BYRD. Thank you, sir.

Senator Boren.

Senator BOREN. I have no questions. I want to endorse what Senator Stone has said. I think he has made the case very well and I think it is very important that we correct the inadequacy in the present rule so that the 19-year-olds will qualify and I commend him for taking the lead in this situation.

Senator BYRD. Thank you very much.

Senator STONE. I ask that my statement be made part of the record.

Senator BYRD. Yes; so ordered.

Senator STONE. I thank you, Mr. Chairman.

Thank you, Senator Boren.

[The prepared statement of Senator Stone follows:]

PREPARED STATEMENT OF SENATOR STONE

Mr. Chairman, I appreciate the Finance Committee granting me the time to speak in behalf of broader employment opportunities for the youth of America. You are well aware of the shamefully high unemployment rate among teen-agers, so I will not dwell on those statistics. In 1978 this Committee, through its conference report, had the foresight to recommend to the Senate an expanded Target Jobs Tax Credit Program including employer tax credits for individuals of ages 16 through 18 who are participants in a qualified high school or vocational school sponsored work-study program. The Committee indicated at that time its intention to focus employment incentives on those individuals who had high unemployment rates, and on groups with special employment needs.

The Labor Department indicates that this program, though not yet fully matured, is having a positive impact: the department's Targeted Jobs Tax Credit report covering activity through August 1979, for example, show that 68.1 percent and 11.2 percent respectively of 14,000 certifications issued went to disadvantaged youth and to handicapped persons. In the work-study category 10,800 students were participants at the end of September 1979. This is a 109 percent increase over the 4,165 reported as cumulative participants in August.

The experience of employers in this program, however, shows that we can do even more to improve the effectiveness of tax credits for youth in work-study programs. Employers have found that the targeted group of 16–18 year olds includes less than 50 percent of the students actually enrolled in work-study and vocational education training. Employers have found that the natural age group for students who work and are at the same time educating themselves for a brighter future is 16 through 19.

If this Committee would accept my bill, S. 1861, which is co-sponsored by Senators Boren, Thurmond, Hollings, and Bentsen, as part of the Technical Corrections Act of 1979, we would qualify 19 year-old vocational education students for the tax credit. We would then impact about 70 percent of students enrolled in work study programs. By making this adjustment in law we would simply and directly accomplish what the Congress intended in 1978, that is to reflect the normal age make-up of persons in these high school programs.

There is no logical reason for excluding 19 year-olds who, because of socio-economic factors, simply take longer to complete a high school education. Nineteen year-olds are ineligible because Congress did not realize that the demography of work-study students programs is not in the traditional high school mold.

I recognize that we, the sponsors of S. 1861, are asking the Committee to make a technical correction that has substantive overtones, but we believe that by enlarging the class of work-study students who would qualify for the tax credit employment incentive, this Committee would do no more than establish the objective desired by the Congress in 1978. Moreover, the Treasury Department stated in recent hearings on this issue in the House of Representatives that it does not oppose such a change; the revenue lost would be minimal.

In summary, when it developed this legislation in 1978, Congress clearly intended to include all students who normally progress through high school and are in work-study programs in order to develop their initial job skills, in the group eligible for the targeted jobs credit. A 16–19 year old grouping clarifies this congressional intent by recognizing the unique nature of the work-study student body. A Finance Committee technical correction that will accomplish this intent would be reasonable, it would be proper and it would be efficient. I urge the Committee to make this improvement in the Targeted Jobs Tax Credit Program.

Senator BYRD. Mr. Ferguson.

I am sorry to have interrupted you, Mr. Ferguson.

Now your testimony first will be on the House-passed proposal, will it?

STATEMENT OF BRADFORD L. FERGUSON—RESUMED

Mr. FERGUSON. Yes, that is correct.

Senator BYRD. I don't want to suggest—is that the way you wish to proceed?

Mr. FERGUSON. Yes. The body of my statement relates entirely to the House-passed bill, and the additions that have been discussed at the staff level are all contained in the attachment.

Senator BYRD. Why don't you first deal with the House-passed legislation?

Mr. FERGUSON. Very well.

I would ask that my entire statement be submitted for the record.

Senator BYRD. Yes.

Mr. FERGUSON. I will summarize very briefly my written remarks.

Senator BYRD. Very good.

Mr. FERGUSON. H.R. 2797 was drafted initially by the staff of the Joint Committee on Taxation. It was drafted after consultation with persons at Treasury and the Internal Revenue Service, with private tax practitioners and other interested individuals. The bill was subjected to hearings before the Ways and Means Committee, and a few additions and a few modifications were added at that point.

Significantly, the bill has remained truly a technical bill. It does not now contain controversial substantive amendments that prolong legislative debate. I believe its limited scope is important, Mr. Chairman, in view of the timing problems that are posed for taxpayers and the Internal Revenue Service. The return-filing season is rapidly approaching for tax year 1979. In view of that fact, the full Finance Committee approved, on October 2 of this year, a list of eight amendments that were especially important for purposes of the IRS forms and the IRS instructions.

Senator BYRD. The committee, as I recall, approved them in principle, but they are still a part of this bill.

Mr. FERGUSON. That is correct.

There are additional items in the House-passed bill that are very important from the standpoint of taxpayer compliance. They should be passed as soon as possible in order to make the law certain, to make it clear for taxpayers.

Senator BYRD. I think the committee could act almost immediately on the House-passed portion of the bill. Now you present the committee with a little different problem, 45 pages of new amendments which we were not aware of, as committee members we were not aware of them until today. My staff first knew of it yesterday.

Mr. FERGUSON. Let me say a few words about the attachment. For the most part, those proposed changes address drafting errors that were not made at the committee level, but were made by staff in the rush of legislative activity in 1978. The proposals relate to decisions that in most cases, were actually made in the drafting sessions as opposed to committee sessions. Mr. Chairman, you are certainly correct in saying that the proposals should be carefully reviewed; I think they should be reviewed with the idea of determining whether or not these modifications more clearly reflect the congressional intent. We hope that a review can be accomplished rapidly. We think each of these proposed amendments is technical, and we hope that this consideration does not delay passage of the bill. We appreciate your concerns in that regard, Mr. Chairman.

Senator BYRD. Let me ask you this. Suppose we take the attachment and ask the Treasury and the Finance Committee staff and the joint committee staff and the subcommittee staff, representatives of those four entities, to go over these proposals and if no problem seems to develop, leave the record open for 2 weeks. I

think in 2 weeks we ought to know from the public whether the public feels it presents any problem. I just feel the public ought to have an opportunity to review the proposed changes. Do you think that 2-week period would be detrimental?

Mr. FERGUSON. No, Mr. Chairman. It is important that the public review what has been proposed in the attachment. I think that can be done within a 2-week period. The persons who are interested in those provisions should be able to receive notice very rapidly. They would read the tax publications, and we could get a very rapid feedback from them.

Senator BYRD. Very good.

Now do you want to comment on the attachment? I don't mean go into every detail of it but are there certain aspects that you think the committee's attention should be called to?

Mr. FERGUSON. Mr. Chairman, a number of these provisions relate to technical changes already in the House bill; in a sense, some of the changes are technical corrections to technical corrections. In reviewing suggested additions to the House bill, the staffs have tried to keep the bill limited; in those cases where we thought a substantive policy issue was involved, we kept the proposal out of the attachment. In our view and in the view of the joint committee staff, and the Senate Finance Committee staff, these are truly technical amendments.

I am not sure it would be worthwhile for me to go into them in any greater detail at this point, Mr. Chairman.

Senator BYRD. Very well. I just happened to look at page 15, specially "Effective date for certain deferred compensation payments to independent contractors." Now what does that do?

Mr. FERGUSON. In the Revenue Act of 1978, there was a statutory change that involved payments made under deferred compensation arrangements. The old rule had said that, if an employer maintained a nonqualified pension, profit-sharing plan or similar plan, he could not obtain a deduction for contributions until the amounts were included in the income of the employee recipients. In 1978, that old rule was expanded to include deferred compensation of independent contractors and was also clarified to apply expressly to plans not ordinarily of the type considered to be pension, profit sharing, or similar plans.

The effective date of the new rule is for taxable years beginning after December 31, 1978. It has come to the attention of staff that, in the case of certain insurance trusts and most particularly in the case of a Florida trust that acts on behalf of some 6,000 attorneys, amounts credited to accounts of member attorneys as commissions on title insurance may technically be considered deferred compensation. To provide security for policyholders, the commissions are generally not paid to the Florida attorneys for at least 7 years after being credited.

In that case, the burdens of complying with the new provisions seem to be more difficult than in the usual case. It is not the garden variety deferred compensation plan with respect to those particular kinds of trusts. It seems reasonable to provide a little more time for them to comply. For that reason, the proposal would provide a 1-year postponement, until taxable years beginning after December 31, 1979, with respect to such commissions by a title

insurance company to its members. The proposed amendment deals with a very limited situation that was really not considered squarely by the committee.

Senator BYRD. Thank you, Mr. Ferguson.

Senator Boren.

Senator BOREN. Mr. Chairman, I have a question in another technical area that is not covered by the bill but it is an area that has been brought to my attention and I think it has come to the attention of the Treasury before. That is, that individuals cannot transfer proven oil and gas property into a corporation in exchange for stock, so-called 315 transfer, without losing percentage depletion on that property. I am talking about individuals who would qualify as independent producers. This is because of an apparent technical deficiency in section 613(a) of the Code which I believe the Department has recognized in bill H.R. 5124 which has been introduced by Congressman Lederer in the House and which I supported to correct the problem. I know that last year there was testimony by Mr. Halpern on this same problem before the House Ways and Means Committee in which he said that since the corporations are permitted to transfer oil and gas properties it is appropriate to provide similar rules for individuals.

I wonder if the Department continues to take that position and if you have any suggestions about what we might do to correct this problem?

Mr. FERGUSON. Senator Boren, as you mentioned at the outset, this particular problem does not relate to the 1978 legislation; it relates to the Tax Reduction Act of 1975. So the amendment is perhaps beyond the scope of the technical corrections bill. However, the Treasury Department continues to believe that this is an unobjectionable proposal. We would not oppose its passage.

The problem arises under the Tax Reduction Act of 1975 because that act seeks to prohibit the proliferation of proven oil and gas property that is eligible for percentage depletion. Percentage depletion was limited by that act, as you know, to small producers. Generally proven property cannot be transferred and remain eligible for percentage depletion. There is currently an exception from the nontransferability rule in the case of a corporation that transfers proven oil and gas property to another controlled corporation. But the exception does not apply in the case of an individual transferor. We see no reason why it should not, so we have no objection to the proposal as you outlined it.

We do have some technical problems with the drafting. We have been in touch with your staff in that regard, and we have talked to the joint committee staff. I think we can work out those problems. At least to my knowledge everyone has the same intent; it is just a question of getting there with the right statutory language. I would suggest, if you are willing, that we could again contact your staff and try to determine the language that everyone can agree upon to accomplish the objective.

Senator BOREN. I appreciate the answer very much and look forward to working with you on it. We are not wanting to expand the scope or the nature of those who are entitled to take percentage depletion or to take advantage of it but that it seems to me we are unduly penalizing individuals who for many reasons may want

to transfer to a wholly owned corporation where you are dealing with the very same individuals, very same producers and I hope we could find a way to do it. We look forward to working with you on it.

Mr. FERGUSON. Thank you.

Senator BYRD. Thank you, Senator Boren.

You might tell the committee just what page 45 of the attachment does?

Mr. FERGUSON. Page 45 relates to a provision that was added in 1978 legislation. The earlier Tax Reform Act of 1976 provides for special estate tax valuation for certain farm property, so that the property can be valued for farm purposes and not at its highest and best use in some other commercial venture. There is a safeguard in the 1976 act to prohibit the heirs of the decedent from transferring the property; the property must be kept within the family for 15 years in order to avoid a recapture of the estate tax benefit.

It was pointed out in 1978 that recapture might be involved in instances where the inherited property was involuntarily converted—for example, through a casualty. Legislation in 1978 waived recapture if the converted property is replaced by similar property of at least as much value. That 1978 rule creates a problem, however. The 1976 act gives the Government a lien against the inherited property to protect the potential recapture amount in the event the property is disposed of prematurely. If that property is converted to another piece of property, the lien may not apply to the same equity interest. Let me give you an example.

If the property that was originally subject to the Government lien had no mortgage debt and was worth $100,000, the Government would have a good lien for up to $100,000 of equity. If, however, that property were converted to property having the same cost, $100,000, the Code does not require that the heir have an equity interest of $100,000. The new property might be purchased for a down payment of perhaps $10,000. In that case, the Government's lien has obviously been substantially eroded. What this amendment would do is to keep the Government on a parity so that its lien would not be impaired by this involuntary conversion.

Senator BYRD. Thank you, Mr. Ferguson.

Do you have another or other bills before the committee today you wanted to comment on?

Mr. FERGUSON. Just two others, Mr. Chairman, and I will be brief.

S. 873 deals with a very limited situation that arises under code sections 911 and 913. As you know, those two sections provide special tax benefits for Americans who live and earn income abroad. There are two alternative requirements for qualifying for the special tax benefits. An individual must either have resided in a foreign country for one entire taxable year or must have been physically present in that country for 17 of 18 months.

The Iranian situation has prompted some concern that persons who could otherwise meet those requirements have been forced to flee the country before the expiration of the 1-year or the 18-month period. This bill is a very limited attempt to zero in on that problem and to permit the Secretary of the Treasury to waive

those requirements where an individual can make a showing that he would have fulfilled them had a war or civil uprising not occurred.

We have no opposition to this bill. We have a couple of minor technical changes that are outlined in my statement. I will not discuss now unless you would like for me to do so.

Senator BYRD. That will not be necessary.

Mr. FERGUSON. The third bill is S. 1549, which deals with an excise tax on sport fishing equipment. The tax is equal to 10 percent of the price charged for this equipment, and the issue is the timing of payment. Under current law, payment must be made to the Government within 9 days after the middle of every month. The bill would defer payment so that generally the tax liability would not be owed until the end of the quarter following the quarter in which the goods were shipped by the manufacturer.

The apparent reason for this change, as stated by the proponents of the bill, is that the manufacturers ordinarily ship the goods throughout the year, grant very liberal credit terms and therefore cannot match payment from the distributor with the excise tax payment to the Government.

We think that these credit terms do not justify a special tax rule, however. We note that other expenses also have to be carried by the manufacturers if they are to use these special credit terms. They have to pay currently their maintenance costs, their utility costs, their wages, and their raw material costs in spite of the credit terms they grant the distributors.

We also fear that this kind of amendment may open the door to other taxpayers who would like the tax system to be accommodated to their own business practices. For those reasons we oppose S. 1549.

Senator BYRD. Do you oppose S. 1549 and you favor S. 873?

Mr. FERGUSON. That is right.

Senator BYRD. Earlier, Mr. Converse Murdoch, representing the Small Business Council of America urged that section 366 of the 1978 act, that the effective date be deferred so that various technical corrections could be made in that section. What would be your view on that?

Mr. FERGUSON. This may be an appropriate time to mention a couple of the provisions in the attachment. There are two proposals, agreed upon at the staff level, that would alleviate the problems that some small businesses may otherwise have with respect to section 366 of the 1978 Revenue Act.

One amendment relates to withholding tax requirements. We have heard the argument that employers may have difficulty in determining the amount of income tax to withhold on medical reimbursements because, in some cases, the taxable amount is not apparent to the employer until the end of the year. Of course, he has to withhold throughout the year. To eliminate that problem, a proposed amendment provides that withholding would not be required with respect to medical reimbursements without regard to whether or not plans discriminate, and therefore result in income to employees, or do not discriminate, in which case there would be no tax liability.

There is a second remedial amendment that relates to the computation of amounts includable in income. The effective date in the Revenue Act of 1978 is with respect to plan years that end after 1979. It was pointed out that, in the case of fiscal year plans, employees might have to take amounts into income for 1980 that related to payments actually made during 1979. The Technical Corrections Act, as passed by the House, makes it clear that no amounts reimbursed prior to 1980 will be included in the income of employees.

In the attachment is a proposal that goes one step further. This additional proposal would say that, for purposes of determining whether or not a reimbursement in 1980 is taxable to the employee, no reimbursements in 1979 would be considered in applying the new rules. The effect of this proposal is not to count discriminatory payments in 1979 against employees in determining the tax treatment of payments in 1980.

So those two amendments have alleviated some of the problems. Of course, in the 1978 act itself there was a general postponement of the effective date through 1979 in recognition of the fact that employers might need some time to comply with the new provisions. We think that, with the changes already in the Technical Corrections Act plus the changes being proposed in the attachment, there is no need for further postponement of the effective date.

Senator BYRD. What types of small businesses use medical reimbursement plans, primarily doctors and lawyers? Is that the situation?

Mr. FERGUSON. In some cases, doctors and lawyers may incorporate for that reason. Many other small businesses, prior to the 1978 act, had provided reimbursements for just one employee, and that limited coverage was the abuse this committee had in mind when the 1978 act was passed.

The problem that the committee saw—and that we saw from the standpoint of Treasury—was not that there is something necessarily wrong with permitting medical reimbursements on a tax-free basis. But if that is done, it should be done for a wide range of employees. Of course, in the pension area there is the requirement that tax benefits be available only if the coverage is nondiscriminatory. The intent in 1978 was to apply a similar type of rule in the health plan area.

Senator BYRD. Section 366 applies only to the self-insured as I understand it.

Mr. FERGUSON. That is right.

Senator BYRD. And not to the insured plans.

Mr. FERGUSON. That is right.

Senator BYRD. Mr. Kiley representing the Norfolk & Western Railway asked the committee for clarification in the way of a technical amendment to section 374. Do you have any comment on that?

Mr. FERGUSON. I was not present for his testimony and I am not sure what he is proposing, Mr. Chairman. It is hitting me out of the blue. Perhaps we could review the statement and be prepared at a later date, at markup or earlier, to give our views on his proposal. I am just not sure what he has in mind at this point.

Senator BYRD. I think that would be better than for the Chair to attempt to explain his position, just let the record speak for itself and then you can make your comment on it.

Mr. FERGUSON. Fine.

[Comment follows:]

Mr. Kiley's proposal relates to the application of the consolidated return regulations under Code section 1502. Upon the disposition of stock of an affiliated corporation, the corporation disposing of that stock must recognize income to the extent of the affiliate's "excess loss account." For this purpose, a disposition is deemed to have occurred if the stock of a subsidiary corporation becomes wholly worthless.

Norfolk and Western Railway is the parent corporation of Erie Lackawanna Railway, which has an excess loss account. Erie Lackawanna is now involved in a reorganization proceeding under the Bankruptcy Act. Since it transferred railroad assets to ConRail in 1976, its financial position depends upon the finding of a special court under the Regional Rail Reorganization Act of 1973.

In Mr. Kiley's statement, he proposes that, for purposes of the consolidated return regulations, the stock of Erie Lackawanna not be considered worthless until the special court determination becomes final. We understand that the excess loss account would nevertheless be triggered no later than the year Erie Lackawanna is removed from the Norfolk and Western consolidated return. We also understand that, under the proposed amendment, Norfolk and Western could take no action subsequent to 1976 that would have the effect of preventing the triggering of an excess loss account with respect to Erie Lackawanna.

Based upon this understanding, we do not object to Mr. Kiley's proposal. However, we would oppose its inclusion in H.R. 2797. This proposal cannot reasonably be considered to be a technical correction to 1978 legislation.

Senator BYRD. There will be two additional panels. Will you be able to stay and then make comment on any of the witnesses that come up subsequently, too?

Mr. FERGUSON. I would be happy to stay if you would like, Mr. Chairman.

Senator BYRD. It might be helpful if you could.

Mr. FERGUSON. Thank you.

Senator BYRD. Thank you.

[The prepared statement and attachment of Mr. Ferguson follow. Oral testimony continues on p. 168.]

STATEMENT OF BRADFORD L. FERGUSON, ASSOCIATE TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. Chairman and members of the subcommittee, I am pleased to have the opportunity to present the views of the Treasury Department on three tax bills. The bulk of my statement will be devoted to H.R. 2797, the "Technical Corrections Act of 1979." The second bill for discussion is S. 873, a proposal to waive in limited instances the foreign residence or physical presence requirement for certain tax benefits accorded individuals living abroad. The third bill is S. 1549, which would defer payment of the excise tax in the case of sport fishing equipment manufacturers.

H.R. 2797 (TECHNICAL CORRECTIONS)

About 1 year ago, in the final days of the 95th Congress, there was a spate of legislative activity in the tax area. The conference reports on three major tax bills—the Revenue Act of 1978, the Energy Tax Act of 1978, and the Foreign Earned Income Act of 1978—were adopted on October 15, 1978. The Revenue Act alone comprises about 200 pages of statutory language and over 100 provisions, with many significant issues being resolved by the House-Senate conferees during the waning hours of the session. The draftsmen performed remarkably well under the severe time pressures; but as expected, there are some technical problems that need to be corrected.

The purpose of H.R. 2797 is to effect the needed technical changes. It deals with four tax acts adopted last Congress: the Revenue Act, the Energy Tax Act, the Foreign Earned Income Act, and the Black Lung Benefits Revenue Act. The bill was drafted initially by the staff of the Joint Committee on Taxation with the aid of

comments from Treasury, the Internal Revenue Service and tax practitioners. A few additional corrections were added to the bill after hearings in the Ways and Means Committee. But significantly, the bill has remained free of controversial substantive changes in the law; H.R. 2797 is simply an effort to reflect more accurately and clearly the Congressional intent underlying the four tax measures just mentioned.

The extraordinary time pressures of last fall make passage of H.R. 2797 especially important; however, the need for technical corrections is not an isolated phenomenon. Regardless of the time devoted to consideration and drafting of statutory language, technical errors are inevitably discovered in major tax legislation. Problems range from clerical oversights, to ambiguous wording, to unforeseen and unintended implications of an amendment. These problems become apparent as IRS and Treasury begin to prepare regulations and forms and as taxpayers and practitioners seek to apply the new provisions to specific fact situations.

Prior to 1977, there was no established mechanism to correct the errors in tax legislation. Taxpayers and tax administrators simply had to deal with the statutes as originally drafted, and to accept many tax results that Congress did not intend. However, with the introduction of the Technical Corrections Act of 1977, a formal procedure was implemented to make technical modifications to the Tax Reform Act of 1976. The 1977 Corrections Act, like the bill you are now considering, was drafted initially by the Joint Committee staff with the cooperation of Treasury, IRS and taxpayer representatives.

Our experience with the 1977 Corrections Act is instructive. Once Congress has made a substantive decision on tax policy, both taxpayers and the Government have a strong interest in assuring that the policy is implemented by proper statutory language; the 1977 Act advanced this objective, and I believe the effort was well received by all individuals concerned with the tax system. At the same time, the process was impaired by delay; technical corrections for the Tax Reform Act of 1976 were not adopted until passage of the Revenue Act of 1978.

The protracted legislative course of the 1977 Corrections Act created a number of problems. For example, the delay affected IRS efforts to make timely and accurate changes in tax forms. A number of changes were made in the 1977 tax forms on the assumption that the pending 1977 Corrections Act would be enacted in 1977. When enactment was postponed until late 1978, the effective date of one of the corrections relating to community property laws and to the credit for the elderly was changed from January 1, 1977 to January 1, 1978—a change that required burdensome corrective action by the IRS to assure that affected taxpayers did not overpay their 1977 taxes.

A similar timing problem may arise in connection with the 1979 Corrections Act. Unless the bill is adopted before the close of this year, many taxpayers will encounter uncertainty and confusion in filing their 1979 tax returns. We believe that such expeditious passage is possible as long as the bill is not encumbered with substantive tax changes. As now drafted, H.R. 2797 is truly "technical" legislation. We hope that controversial provisions will continue to be excluded during Senate consideration of the bill.

Items already approved by Finance Committee

In view of the timing problems raised by the impending tax filing season, the Finance Committee has already approved a portion of H.R. 2797. On October 2, 1979, the Committee adopted eight technical corrections that are especially important for IRS administration. All of these changes are reflected in the 1979 tax forms and instructions that the IRS began printing last month.

The provisions already approved by the Committee are the following:

The Revenue Act of 1978 includes a new provision for an alternative minimum tax, payable if it exceeds the sum of a taxpayer's regular tax and add-on minimum tax liability. Under the new provision, alternative minimum taxable income is computed by subtracting all deductions from gross income and then adding back certain preference items. H.R. 2797 would permit persons who do not itemize deductions to use the zero bracket amount (formerly known as the standard deduction) in computing the alternative minimum tax.

As now drafted, the alternative minimum tax provision permits a new operating loss to provide a double tax benefit. Through a drafting error, the loss can be deducted currently in computing the alternative minimum tax and can also be carried over to reduce the tax liability of other taxable years. H.R. 2797 would correct this defect by prohibiting the deduction of a net operating loss against alternative minimum taxable income in those instances where the loss can be carried to another year.

The alternative minimum tax is imposed to the extent it exceeds a taxpayer's regular tax (including the add-on minimum tax). Certain "penalty" taxes are ex-

cluded from the definition of "regular tax" and thereby do not reduce the alternative minimum tax. The Revenue Act expressly excluded from the "regular tax" definition such penalties as the taxes imposed on premature distribution from a certain pension and annuity plans or from individual retirement accounts. H.R. 2797 would extend the same treatment to the "penalty" tax imposed on premature redemptions of retirement bonds.

Under the alternative minimum tax, one of the tax preference items is "adjusted itemized deductions." The preference is deemed to result when certain itemized deductions exceed 60 percent of adjusted gross income (with modifications). The literal language of the Revenue Act requires, in the case of trusts and estates, that some deductions be counted twice in arriving at the modified adjusted gross income figure. The effect is to increase artifically the alternative minimum tax liability of a trust or estate. H.R. 2797 would rectify this error.

Present law permits deductions for state and local taxes to be excluded in computing the tax preference for adjusted itemized deductions. Under H.R. 2797, a deduction for foreign taxes would also be excluded from the preference.

The Revenue Act liberalized the rules for computing a cooperative's investment tax credit and permitted investment credits unused at the cooperative level to be flowed-through to its patrons. H.R. 2797 would make conforming changes so that the new rule would also apply to computation of the work incentive (WIN) credit and the jobs tax credit.

The Foreign Earned Income Act eliminated a prior requirement that taxable income be stacked in rate brackets on top of income excluded (under section 911) by Americans working abroad. With this change, it is appropriate for individuals who exclude foreign earned income to use the tax tables, and H.R. 2797 would so provide.

Articles sold as supplies for fishing vessels are not subject to the 4 cents-a-gallon excise tax on fuels or the 6 cents-a-gallon tax on lubricating oil. However, a tax-free sale is often not available in the case of commerical fishing because the producer or supplier does not know the purpose for which the item is to be used or the intermediate seller does not want to perform the necessary paperwork to obtain the tax benefit. The Energy Tax Act eliminated a prior provision that permitted the purchaser to obtain a direct refund of 2 cents-a-gallon with respect to fuels and 6 cents-a-gallon with respect to lubricating oil. Since Congress did not intend to change the excise tax exemptions for commerical fishing vessels, H.R. 2797 would restore the 2-cent and 6-cent direct refunds where items are used on a commerical fishing vessel.

Other provisions in H.R. 2797

In addition to the eight items considered by the Finance Committee last month, the Technical Corrections bill contains 71 other amendments, not including changes that are purely clerical in nature. Detailed descriptions of these provisions are sent forth in the pamphlet prepared by the Joint Committee staff. Today, I would like to mention just a few of the most important of the provisions not yet considered on the Senate side.

Three amendments are necessary to coordinate properly the investment credit provisions contained in the Revenue Act and the Energy Act.

The Revenue Act was designed to make the investment credit permanent at a 10-percent rate, rather than reverting after 1980 to a 7-percent rate as scheduled under prior law. However, the Energy Act restated the investment credit provisions of old law and was formally enacted after the Revenue Act. As a result, the Code may still technically retain a December 31, 1980 expiration date for the 10-percent credit. H.R. 2797 would clarify Congressional intent to make the 10-percent rate permanent.

Certain equipment may qualify for both the regular 10-percent investment credit and in additional 10-percent credit for energy property acquired after September 30, 1978 and before January 1, 1983. Under the Revenue Act, only one-half of the otherwise qualified investment is eligible for the regular investment credit where the taxpayer uses the special 5-year amortization provision for pollution control facilities and also finances the facilities with tax-exempt bonds. Congress intended also to reduce the special energy investment credit to 5 percent in the case of energy property, including certain pollution control equipment, financed by tax-exempt bonds. But through interaction of the two provisions, the energy credit is effectively only 2.5 percent with respect to pollution control equipment subject to the limitations on the regular investment credit. This result was not intended, and the bill would amend the Code to provide a 5-percent energy investment credit to this property.

The Revenue Act extends the regular investment credit to certain rehabiliation expenditures attributable to buildings that are at least 20 years old. To preclude the

claiming of a double regular investment credit, the credit for rehabilitation expenditures is denied for property qualifying under other investment credit rules. As now written, the Code also prohibits a taxpayer from claiming both the energy investment credit and the regular investment credit for rehabilitation expenditures that qualify as expenditures for energy property. The bill would correct this unintended result.

Under the Revenue Act, no deduction is generally allowed for expenses incurred with respect to entertainment facilities. The Act specifically excepts "country club dues" from the new deduction disallowance rule. Congress did not intend the exception to be so restricted, and the bill would reflect the Congressional intent by deleting the word "country" from the exception for club dues.

The Revenue Act increased the capital gains deduction from 50 percent to 60 percent for individuals (so that 40 percent of individual capital gains would be subject to tax) and also reduced the alternative capital gains tax rate for corporations from 30 percent to 28 percent. H.R. 2797 contains several technical amendments to correct drafting errors and to clarify the application of these capital gains changes. Among the technical corrections are the following:

Prior to the Revenue Act, an individual in high rate bracket could elect to have the first $50,000 of capital gains taxed at a 25 percent rate in lieu of deducting one-half of capital gains from gross income. This special "alternative tax" for individuals was repealed for taxable years beginning after December 31, 1978. Through inadvertence, the rules for calculating the alternative tax for taxable years prior to repeal were not altered to reflect the increase in the capital gains deduction from 50 percent to 60 percent. After consulting with Treasury staff and the Joint Committee staff, the Internal Revenue Service prepared its 1978 tax forms and instructions as though the conforming change were properly made, and the Technical Corrections bill would now formally correct this oversight in the Revenue Act.

The increase in the capital gains deduction for individuals was made effective for sales or exchanges after October 31, 1978. The reduced alternative capital gains rate for corporations was made effective for sales or exchanges after December 31, 1978. Left unclear was the treatment of payments received after the respective effective dates for sales or exchanges occurring before the effective dates. Under H.R. 2797, the capital gains tax reductions would apply in instances where the income is properly taken into account by the seller during a period after October 31, 1978 (in the case of individuals) or after December 31, 1978 (in the case of corporations).

Another important change relates to the effective date of the targeted jobs credit. The Revenue Act was drafted to make the targeted jobs credit effective for wages paid or incurred through December 31, 1980. The statement of conference managers indicates that the expiration date is to be December 31, 1981. The statement of managers reflects the correct Congressional intent, and the Technical Corrections bill would rectify the clerical error in the Act.

Additions to H.R. 2797

Subsequent to the House adoption of H.R. 2797, numerous additions and modifications have been proposed. In consultation with the Finance Committee staff and Treasury staff, the staff of the Joint Committee on Taxation has compiled a list of those proposals that appear to fall within the proper scope of the Technical Corrections bill. A description of these items is attached to my statement. Treasury does not object to any of these items, and we support the adoption of the attached package of amendments to the bill.

S. 873 (AMERICANS ABROAD)

S. 873 would waive in certain cases the foreign residence or physical presence requirement which otherwise must be met by individuals living abroad in order to qualify for certain tax benefits. The Treasury Department does not oppose this legislation.

Present law provides a deduction for certain excess living costs incurred by individuals who have been resident in a foreign country for at least 1 taxable year or who have been physically present in a foreign country for at least 510 days in an 18-month period. Alternatively, certain individuals who live in camps and who satisfy this residence test or physical presence test may elect to exclude a limited amount of income earned abroad.

In the case of individuals who are required to leave a foreign country because of war or civil unrest before qualifying for the deduction or exclusion, subsection (a) of S. 873 would give the Secretary of the Treasury, after consultation with the Secretary of State, the authority to waive the residence or physical presence requirement if the individual establishes that he could reasonably have been expected to have

met such requirement had not the war or civil unrest occurred. The bill is intended to provide relief to American employees who were forced to leave Iran before qualifying under the residence or physical presence test, as well as to others in similar circumstances. We believe that such relief is warranted and that the bill is suitably tailored to address the narrow circumstances contemplated. Accordingly, the Treasury Department does not oppose this legislation.

We do have some technical comments, however. Subsection (b)(1) of the bill provides that its relief provisions shall apply to taxable years beginning after December 31, 1976. Since the bill would amend section 913, its effective date should not be earlier than the effective date of section 913. Specifically, the amendment to section 913 should apply to taxable years beginning after December 31, 1977, or, in the case of taxpayers who made an election pursuant to section 209(d) of the Foreign Earned Income Act to have prior law (*i.e.*, section 911 as amended by the Tax Reform Act of 1976) apply to the 1978 taxable year, to taxable years beginning after December 31, 1978.

Section 913 generally replaced section 911 and subsection (b)(3) of the bill effectively provides that the Secretary shall apply analogous rules for the 1978 taxable year of indivudals who made the election under section 209(c) of the Foreign Earned Income Act to have section 911 apply for that year. This raises two additional technical issues. First, consistent with subsection (b)(1), subsection (b)(3) should apply only with respect to individuals who, after September 1, 1978, left the foreign country in which they were resident or physically present. Second, consideration should be given to allowing taxpayers to qualify for tax year 1977 despite their premature departure. Taxpayers who might fail to qualify for 1977 are those who arrived in Iran late in 1977 and were forced to leave Iran before completion of an 18-month period or before completion of a full year's residence in 1978. The suggested change, which would ensure a partial exclusion for the portion of the 1977 year during which the individuals were abroad, could be accomplished by inserting at the beginning of subsection (b)(3) the language "With respect to the taxable year of an individual beginning during 1977, or . . . ."

S. 1549 (FISHING EQUIPMENT)

S. 1549 would defer payment of the manufacturers' excise tax in the case of sport fishing equipment manufacturers. Under present law, payment of the tax is due by the ninth day following the end of each semimonthly period. S. 1549 would generally postpone the due date until the end of the quarter following the quarter in which the taxable article is shipped; however, existing law would continue to apply with respect to sales made during the last quarter of the Federal fiscal year (i.e., July 1 through September 30). This proposal is virtually identical to section 7 of H.R. 5505, which has recently been passed by the House.

The bill is designed to match payment of the excise tax with the manufacturers' gross receipts. Apparently, the seasonal retail sales pattern for sport fishing equipment leads manufacturers to grant lengthy credit terms to distributors, so that the latter will increase stock during the off-season and enable the manufacturers to produce at a more even pace. Under present law, the manufacturers thus may pay the excise tax before they receive payment from their distributors.

However, the extended credit terms of the manufacturers also require them to finance all other expenses (rent, wages, raw materials, etc.) for some time before receiving payment from their distributors. S. 1549 would have the effect of delaying payment of the excise tax more than that of other expenses of the manufacturers. We do not believe such a special tax deferral is warranted, and we therefore oppose S. 1549.

Different trades have different customary credit terms, which are structured to facilitate operations and to maximize profits. Since the credit terms of an industry are for the benefit of the industry, Treasury sees no reason why the time of payment of excise taxes should be varied for different industries depending on the usual credit terms in the industry. If a special rule is fashioned for fishing equipment, other special rules may have to be given to other industries which have unique business practices.

CONCLUSION

Mr. Chairman, in closing let me reemphasize the important of the Technical Corrections bill. H.R. 2797—and the proposed staff amendments—represent an important effort to relieve confusion and unintended hardship for taxpayers. To achieve the purpose of the bill, prompt passage is critical. Therefore, we urge that H.R. 2797 remain technical and that its consideration not reopen substantive policy debate on the scores of tax issues addressed in 1977 and 1978.

ATTACHMENT

Treatment of Earned Income Credit in AFD and SSI Programs.—(Section 101(a)(2)(A) and (B) of the Technical Corrections Act and sections 402 and 1612 of the Social Security Act.)

The Technical Corrections Act, as passed by the House, amends the Social Security Act to specify that the earned income credit—including both the portion received in advance payment and the portion received as a tax refund—is to be treated as earned income for the purposes of the AFDC and SSI programs. The proposed amendment would make it clear that, if advance payments of the earned income credit exceed the actual credit so that the individual must return the difference, the welfare agency would give some reconciling increase in AFDC or SSI benefits. The procedures for computing this increase would be provided in regulations by the Secretary of Health and Human Services.

Clarification of Effective Dates of Coordination of Investment Credit Rules for Pollution Control Equipment.—(Section 103(a)(2) of the Technical Corrections Act and sections 46(c)(5)(B) and 48(l)(1) of the Code.)

Section 103(a)(3) of the Technical Corrections Act deals with coordinating the changes made to the general limitation on credits for pollution control equipment (Code section 46(c)(5)(B)) with a specific limitation for purposes of the energy credit for energy property, including certain pollution control equipment (Code section 48(l)(11)). If both limitations apply to pollution control equipment eligible for the energy credit, this credit is reduced to an effective rate of 2.5 percent. The Technical Corrections Act, as passed by the House, would make the general limitation inapplicable for purposes of the energy credit. This technical correction is effective on January 1, 1979.

However, the energy credit became effective 3 months earlier, on October 1, 1978, and the interaction of the old (pre-1979) general limitation and the energy credit limitation will also cause the effective rate of the energy credit for pollution control equipment to be only 2.5 percent during the period from October 1, 1978 through December 31, 1978.

The proposed amendment would address this problem by making the effective date for the technical correction as if it were included in the relevant provision of the Energy Tax Act of 1978, rather than the Revenue Act of 1978, so that it would become effective at the same time as the energy credits on October 1, 1978.

Rules for Work Incentive Credit and Targeted Jobs Credit for Cooperatives.—(Section 103(a)(4) of the Technical Corrections Act of 1979 and sections 50B(f), 52(f), and 52(h) of the Code.)

Prior to the Revenue Act of 1978, special rules applied for purposes of determining the amounts of work incentive (WIN) credit and general jobs credit which could be used by cooperatives. These special rules applied the same rules under which the amount of investment credit for cooperatives was determined. The Revenue Act of 1978 revised the rules pertaining to the investment credit for cooperatives. However, it did not change the rules pertaining to the WIN and jobs tax credits for cooperatives. The Technical Corrections Act, as passed by the House, provided that the new rules for investment credit of cooperatives would also apply to the WIN and jobs tax credits. this amendment was accomplished by adding a cross reference in the WIN credit (Code section 50B(f)) and the jobs tax credit (Code section 52(f)). This amendment is to be effective for taxable years ending after October 31, 1978 (the same effective date as the change in treatment of investment tax credit). However, the provision now described in section 52(f) of the Code was numbered section 52(h) of the Code. This renumbering was effective for wages paid or incurred after December 31, 1978, in taxable years ending after that date. As a result, the amendment in the Technical Corrections Act, as passed by the House, does not cover wages paid or incurred in the period between October 31, 1978 and December 31, 1978. The proposed amendment would correct this result so that wages paid or incurred by a cooperative during the period from October 31, 1978 to December 31, 1978 would qualify for the new treatment.

Application of Withholding Tax to Medical Reimbursements.—(Section 103(a)(10)(A) of the Technical Corrections Act and section 3401(a)(19) of the Code.)

Prior to the Revenue Act of 1978, medical reimbursements paid to, or on behalf of, an employee under a self-insured medical reimbursement plan of an employer generally were excluded from the employee's gross income and were not subject to withholding tax. Under the Act, such payments may be fully or partly includable in an employee's gross income for a year if the medical reimbursement plan discriminates in favor of highly compensated individuals for the year, and such payments are subject to withholding tax and reporting if they are includable.

The Technical corrections Act, as passed by the House, provides an exclusion from withholding tax for amounts paid under a medical reimbursement plan for an employee if it is reasonable to believe that the employee will be allowed to exclude the payment from gross income under the rules applicable to such plans. The proposed amendment would provide an exclusion from withholding tax for all amounts paid under such a plan regardless of whether it was reasonable to believe that such payments would be excludable from gross income. However, reporting of taxable payments would continue to be required.

Clarification of Effective Date for Medical Reimbursement Plans.—(Section 103(a)(10)(D) of the Technical Corrections Act and section 366(b) of the Revenue Act of 1978.)

Under the rules provided by the Revenue Act of 1978 for self-insured medical reimbursement plans, excess reimbursements made during a plan year are includable in the gross income of a highly compensated individual for the taxable year in which (or with which) the plan year ends.

The Technical corrections Act, as passed by the House, provides that the medical reimbursement plan rules apply only to reimbursements paid after December 31, 1979. However, the legislative history indicates that, in determining the taxability of reimbursements made under a fiscal year plan, the employee coverage and benefits provided by a plan for its entire plan year beginning in 1979 will be taken into account. the proposed amendment would provide that payments made in 1979 would not be taken into account in determining whether payments made after 1979 are taxable.

Clerical Amendments Relating to Capital Gains Changes.—(Section 104(a)(3)(C) of the Technical Corrections Act and section 593(b)(2)(E)(iv) of the Code.)

For purposes of computing the addition to reserves for bad debts of a thrift insitution, taxable income is determined by excluding the effective amount of net capital gains not subject to tax. The Technical corrections Act, as passed by the House, would change the computation to conform to the reduction in the top corporate tax rate and in the alternative tax rate on corporate capital gains. However, that change does not take into account the different rates in effect during a transitional period prescribed in the Revenue Act of 1978. The proposed amendment would correct this error.

Clarification of Tax Treatment of Cooperative Housing Corporation Upon Death of Promoter.—(Section 531 of the Revenue Act of 1978, section 105(a)(6) of the Technical Corrections Act, and section 216(b)(6) of the Code.)

A tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid to such a corporation to the extent such amounts represent his or her proportionate share of allowable real estate taxes and interest relating to the corporation's land and buildings (section 216). In general, for a corporation to qualify as a cooperative housing corporation (which can pass through these deductions to tenant-shareholders), 80 percent or more of the gross income of the cooperative housing corporation must be derived from individual tenant-stockholders.

Under the Revenue Act of 1978, as modified by the House version of the Technical Corrections Act, if an original seller (*e.g.*, promoter) acquires stock of a cooperative housing corporation either from the corporation or, in certain cases, by foreclosure, the original seller shall be treated as a tenant-stockholder for a period of not to exceed 3 years from the date of the acquisition of the stock.

Neither the 1978 Act nor the Technical Corrections Act, as passed by the House, indicate the tax treatment of the corporative housing corporation where the original seller dies within the 3-year period. The proposed amendment would allow the estate of the promotor to qualify the cooperative housing corporation for the same tax treatment as if the promotor had not died.

Cash Distributions from Employee Stock Ownership Plans After December 31, 1978.—(Section 101(a)(6)(B) of the bill and sections 409A(h) and 4975(e)(7) of the Code.)

The tax credit employee stock ownership plan provisions of the Revenue Act of 1978 generally applied with respect to qualified investment for taxable years beginning after December 31, 1978. The Technical Corrections Act, as passed by the House, specifies the effective date of the provisions with respect to ESOPs. Under the Technical Corrections Act, the cash distribution option provided in section 409A(h) of the Code would not apply to ESOPs until after December 31, 1979.

The proposed amendment would provide that cash distributions made from an ESOP after December 31, 1978 and before July 16, 1979, would be permissible.

Limitation on Election to Have New Tax Credit Employee Stock Ownership Plan Rules Apply 1 Year Early.—(Section 101(a)(6)(B) of the bill.)

The Technical Corrections Act would allow taxpayers to elect to have the new tax credit employee stock ownership plan rules apply to taxable years beginning after

December 31, 1977, rather than December 31, 1978. The proposed amendment would limit this election to plans adopted after December 31, 1978.

Election to Have New Put Option Rules Apply in Employee Stock Ownership Plans.—(Section 101(a)(6)(B) of the Technical Corrections Act.)

Under the Technical Corrections Act as passed by the House, an employer would be permitted to elect to have the new put option rules apply to all employer securities held by a tax credit employee stock ownership plan which are not readily tradable on an established market. The election could be revoked only with the consent of the Secretary.

The proposed amendment would delete this provision from the Technical Corrections Act because there is no need for legislative action. It is understood that the Secretary of the Treasury, under regulations, can, under present law, allow such an election (and revocation of election) of the new put option rules with respect to both tax credit employee stock ownership plans and employee stock ownership plans.

Definition of Employer Securities for Employee Stock Ownership Plans.—(Section 101(a)(6)(C) of the Technical Corrections Act and section 4975(e)(8) of the Code.)

The Technical Corrections Act, as passed by the House, amends the definition of qualifying employer securities for purposes of the prohibited transaction loan exemption available to employee stock ownership plans. The proposed amendment would make clear that this change in the definition of qualifying employer securities does not affect the status of employer securities acquired before December 31, 1979, which constituted qualifying employer securities as defined in section 4975(e)(8) of the Code at the time they were acquired.

Special Effective Date for Certain Deferred Compensation Payments to Independent Contractors.—(Section 133 of the Revenue Act of 1978.)

Prior to the Revenue Act of 1978, section 404(a)(5) of the Code provided that where an employer deferred payment of compensation to an employee pursuant to a nonqualified plan, the employer could deduct the compensation only in the year in which the compensation was includable in the employee's gross income. If the payment was not made pursuant to a qualified plan, but pursuant to a "method of employer contributions or compensation [having] the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation * * *," the deduction-timing limitations of section 404(a) were also applicable.

Section 133 of the Revenue Act of 1978 added new Code section 404(d) which extends the deduction-timing limitation of section 404(a) to payments of deferred compensation made to independent contractors. Section 133 of the Revenue Act of 1978 also amended Code section 404(b) by changing the words "or similar plan" to read "or other plan." The provisions apply to deductions for taxable years beginning after December 31, 1978.

The proposed amendment would generally provide that the changes made by section 133 of the Revenue Act of 1978 would not be effective until taxable years beginning after December 31, 1979, in the case of a plan which defers payment of certain commissions by a title insurance company to its members.

Employee Stock Ownership Plans Name Change.—(Section 141 of the Revenue Act of 1978 and sections 46, 48, 56, 401, 409A, 415, 4975 and 6699 of the Code.)

The Revenue Act of 1978 changed the names given to employee stock ownership plans. Under the Act, employee stock ownership plans were renamed "leveraged employee stock ownership plans," and TRASOP's were renamed "SEOP's."

The proposed amendment would again change these names. A leverage employee stock ownership plan would be called an "ESOP" (as it was before the 1978 Act). An ESOP (TRASOP, as it was known before the 1978 Act) would be called a "tax credit employee stock ownership plan."

Amount of Matching Employer Contributions to a Tax Credit Employee Stock Ownership Plan.—(Section 131 of the Revenue Act of 1978 and section 48(n)(1)(B)(i) of the Code.)

The 1978 Revenue Act continued the provision of prior law which allows a taxpayer to elect an additional one-half of 1 percent investment tax credit if employer securities (or cash used to acquire employer securities) are transferred to a tax credit employee stock ownership plan and are matched by employee contributions. However, the Code, as amended by the Revenue Act, does not provide an effective limitation on the qualified employee matching contributions which must be matched by the employer in order to obtain the credit. The proposed amendment would provide that in order for the taxpayer to be eligible for the additional one-half percent credit, the taxpayer must transfer securities having an aggregate value at least equal to the lesser of the sum of qualified matching employee contributions or one-half of 1 percent of the taxpayer's qualified investment for the taxable year.

Time for Contribution of Matching Employer Contributions to Tax Credit Employee Stock Ownership Plan.—(Section 141 of the Revenue Act of 1978 and section 48(n)(1)(C) of the Code.)

Prior to the Revenue Act of 1978, employers were generally required to contribute any matching employer contributions to a tax credit employee stock ownership plan within 30 days after the time for filing the corporate income tax return for the taxable year for which the investment credit was taken. Employees were given up o 24 months after the close of that taxable year to make matching employee contributions.

The proposed amendment would clarify the rule relating to the time of for making matching employer contributions to a tax credit employee stock ownership plan by allowing employers to make the matching employer contributions at the time of matching employee contributions are made.

Voting Rights for Participants in Employee Stock Ownership Plans.—(Section 141 of the Revenue Act of 1978 and section 409A(e) of the Code.)

Under the Revenue Act of 1978, employee stock ownership plans are required to allow participants to direct the trustee in the manner in which employer securities allocated to the participants accounts are to be voted. Full voting direction is required where the employer has a registration-type class of securities. Limited voting direction (*i.e.*, only on major corporate issues) is required where the employer does not have a registration-type class of securities.

The amendment would repeal the requirement for limited direction of voting under an employee stock ownership plan where the employer does not have a registration-type class of securities. However, employee stock ownership plans would still be subject to the general rule that a defined contribution plan which is established by an employer whose stock is not publicly traded and which has more than 10 percent of the plan assets invested in securities of the employer will be required to pass through voting rights to employees on major corporate issues.

Rules for Time of Establishing a Tax Credit Employee Stock Ownership Plan.—(Section 141 of the Revenue Act of 1978 and section 409A(f) of the Code.)

The proposed amendment would clarify section 409A(f) in two ways. First, it would provide that a tax credit employee stock ownership plan will not fail to meet the requirements of Code section 401(a) merely because it is not established by the close of the employer's first taxable year for which the employer claims a tax credit for contributions to the plan. Second, it would provide that a tax credit employee stock ownership plan will fail to meet the requirements of section 409A of the Code unless it is established before the due date for filing the employer's tax return (including extensions) for the first taxable year for which the employer claims a tax credit for contributions to the plan.

Definition of Employer Securities for Employee Stock Ownership Plan Purposes.—(Section 141 of the Revenue Act of 1978 and section 409A(l) of the Code.)

The Revenue Act of 1978 added to the code a definition of employer securities for purposes of tax credit employee stock ownership plans and ESOP's.

The proposed amendment would make three changes in this definition.

First, the proposed amendment would make clear that where an employer has not issued readily tradable common stock, the term "employer securities" will include common stock issued by the employer which has a combination of voting power and dividend rights equal to the class of common stock with the greatest voting power and the class of common stock with the greatest dividend rights.

Second, the proposed amendment would provide that, under regulations to be issued by the Secretary, convertible preferred stock would be included in the definition of employer securities where such stock is subject to a call which would either (1) cause the preferred stock to be exchanged for other employer securities, or (2) cash out the preferred stock subject to the right of the holder of the preferred stock to convert the preferred stock into common stock.

Finally, the proposed amendment would make clear that the definition of employer securities would include preferred stock which is convertible into common stock which is not readily tradable.

Unrealized Appreciation in Employer Securities.—(Section 142 of the Revenue Act of 1978 and sections 402 and 2039 of the Code.)

The proposed amendment would make it clear that in order for a lump sum distribution from a pension plan to qualify for the estate tax exclusion, it is not necessary to include in gross income the net unrealized appreciation in employer securities received in such distribution.

Integration of Simplified Employee Pensions with Social Security.—(Section 152 of the Revenue Act of 1978 and section 408(k) of the Code.)

The provisions relating to simplified employee pensions, as added by section 152 of the Revenue Act of 1978, allow an employer to take into account contributions or benefits provided by the employer under the Federal Insurance Contribution Act, and in certain cases, require an employer to take into account payments made with respect to the tax on self-employment income. However, this provision was not intended to allow an employer to maintain both a conventional pension plan qualified under section 401(a) of the Code and a simplified employee pension where each plan is integrated with social security. Therefore, under the proposed amendment, a SEP could be integrated with social security only in those situations where the employer does not maintain any other tax-qualified plan which provides for integration of employer contributions or plan benefits with social security contributions or benefits.

Reporting Requirement for Simplified Employee Pensions.—(Section 152(b) of the Revenue Act of 1978 and sections 408(l) and 6693(a) of the Code.)

The Revenue Act of 1978 created a new type of retirement plan, known as a "simplified employee pension" ("SEP"). The Revenue Act requires an employer who makes contributions on behalf of an employee to a SEP to provide reports to the employee with respect to such contributions. However, no express provision is currently included in the Code to impose penalties if an employer fails to furnish required information to an employee.

Unless employers timely report the amount contributed to the SEP, employees will lack the information required to take the appropriate deduction on their tax returns. Therefore, the proposed amendment would extend to SEP's the current penalty relating to failure to provide reports on individual retirement accounts or annuities. This penalty is $10 for each failure unless the failure is due to reasonable cause.

Aggregation of Simplified Employee Pensions with Other Plans.—(Section 152(g)(3) of the Revenue Act of 1978 and section 415(e)(5) of the Code.)

The Code limits the "annual additions" (employer contributions, forfeitures and, in some circumstances, a portion of employee contributions) that may be allocated to a participant's account in a defined contribution plan for any year. For this purpose, an individual retirement account or annuity ("IRA") is aggregated with other defined contribution plans of an employer if the participant for whom the IRA is maintained is in "control" of the employer. As drafted, the Revenue Act treats simplified employee pensions ("SEP's") the same as IRA's under the aggregation rule, so that a SEP for the benefit of a participant will be aggregated with the defined contribution plan of an employer only where the participant is in "control" of the employer.

A broader aggregation rule was intended with respect to SEP's. The legislative history of the Revenue Act of 1978 comtemplates that employer contributions to a SEP are to be taken into account as employer contributions to a defined contribution plan under the "annual addition" limitations in all cases, without regard to whether the employee is in control of the employer. The proposed amendment would effect this change.

Penalty for Failure to File a Partnership Return for Underwriting Syndicates.—(Section 211 of the Revenue Act of 1978 and section 6698 of the Code.)

The Revenue Act of 1978 imposed a penalty on the failure to file a partnership return. Historically, partnership returns have not been filed in the case of syndicates of dealers in securities formed for the purpose of underwriting, selling or distributing securities. The proposed amendment would provide an exception to the penalty for failure to file a partnership return in such a case.

Computation of Tax From Foreclosure Property of a Real Estate Investment Trust.—(Section 301 of the Revenue Act of 1978 and section 857(b)(4)(A) of the Code.)

Under present law, a tax is imposed on the net income from foreclosure property of a real estate investment tax. The tax is determined using the corporate rates with a surtax exemption of zero. The Revenue Act of 1978 removed the surtax exemption for corporations and replaced it with a graduated rate schedule. The proposed amendment would make a conforming amendment providing that the tax on net income from foreclosure property of a real estate investment trust is to be computed at the highest rate applicable to corporations.

WIN Credit for Subchapter S Corporations and Estates and Trusts.—(Section 322 of the Revenue Act of 1978 and section 50B (d) and (e) of the Code.)

The Revenue Act of 1978 provides that an employer's deduction for wages is reduced by the amount of WIN credit allowable (Code section 280C(a)). However, for estates, trusts, and subchapter S corporations, the credit is computed by individual beneficiaries and shareholders, who are not allowed deductions for the wages paid by the estate or corporation. Thus, the new provision is inconsistent with the

current law method for the computation of the WIN credit by beneficiaries and shareholders. The proposed amendment would provide that the WIN credit is to be computed by the estate, trust or subchapter S corporation, rather than by individual shareholders and beneficiaries. The deduction of the estate, trust or subchapter S corporation will be reduced by the amount of WIN credit allowable.

WIN Credit for Child Care Expenses Between October 1, 1978, and December 31, 1978.—(Section 323 of the Revenue Act of 1978 and section 50B(a)(2)(B) of the Code.)

The WIN credit, as in effect before the amendments of the Revenue Act of 1978, contained a provision denying the credit in connection with services performed after October 1, 1978, in connection with a child day services program. The Revenue Act permits a WIN credit for such services performed after December 31, 1978. The proposed amendment would repeal the termination date under prior law to avoid a 3-month gap in WIN credit coverage.

Correction of Typographical Error.—(Section 337(a) of the Revenue Act of 1978.)

The proposed amendment would correct a typographical error in section 337(a) of the Revenue Act of 1978 by changing "or a refund profit" to "of a refund profit".

Clarification of the Limitation on the Nondeductibility of Certain Entertainment Facility Expenses Includable in Income.—(Section 361 of the Revenue Act of 1978, and section 274(e) of the Code.)

Prior to the enactment of the Revenue Act of 1978, expenses incurred with respect to entertainment facilities* were deductible if they were ordinary and necessary, the facility was used primarily for the furtherance of the taxpayer's business (*i.e.*, more than 50 percent of the time that it was used), and the expense in question was related directly to the active conduct of the taxpayer's business. For this purpose, entertainment facility expenses included dues or fees paid to any social, athletic, or sporting club or organization. Dues or fees paid to professional associations, civic organizations, or to clubs operated solely to provide meals under circumstances normally considered to be conducive to business discussions generally were not considered to be entertainment facility expenses.

The Revenue Act of 1978 provided generally that no deduction was allowable for any entertrainment facility expense. However, the Act retained a number of exceptions to the general rule that existed under prior law. One of these relates to expenses treated as employee compensation which are subject to withholding (section 274(e)(3)). The proposed amendment provides an exception from the facility expense deduction disallowance rule in the case of expenses for individuals who are not employees if the taxpaper files an information return with respect to the amount includable in the individual's gross income (regardless of the amount involved).

Clarification of Treatment of Liabilities of Controlled Corporation.—(Section 365(a) of the Revenue Act of 1978 and section 357(c)(3) of the Code.)

The Revenue Act of 1978 provided that where a cash basis taxpayer transfers property to a controlled corporation subject to certain liabilities, then certain "accounts payable" would not be taken into account in determining the amount of gain recognized by the transferor on the transfer. The legislative history indicates that the taxpayer could also qualify under this provision where he was using a hybrid method of accounting. The legislative history also indicates that "accounts payable" would include trade accounts payable and other liabilities (*e.g.*, interest and taxes) which relate to the transferred trade or business. Thus, the legislative history indicates that the scope of the provision is intended by Congress is broader than the literal language of the statute would seem to indicate. The proposed amendment clarifies the statutory language consistent with the intent of Congress by deleting the requirement that the taxpayer be using the cash method of accounting and that the liabilities to be disregarded must be "accounts payable".

Relationship of the Recapture of the Investment Tax Credit and WIN Credit and the Alternative Minimum Tax.—(Section 421(a) of the Revenue Act of 1978 and section 55(b)(2) of the Code.)

The Revenue Act of 1978 imposed a new alternative minimum tax on individuals. The tax is the amount by which the gross alternative minimum tax exceeds the "regular tax" on the taxpayer. In determining the taxpayer's regular tax, certain penalty taxes are not taken into account. However, no adjustment to regular tax is made for the recapture of investment tax credit or WIN credit. As a result, there is no additional tax by reason of the recapture of the investment tax credit or WIN credit in any year where the alternative minimum tax occurs. The proposed amend-

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* An entertainment facility generally is any item of personal or real property owned, rented, or used by a taxpayer during the taxable year for, or in connection with, an activity normally considered to be of an entertainment nature.

ment would correct this problem by excluding recapture of investment tax credit and WIN credit from the definition of regular tax.

Allocation of Tax Preference Items in the Case of Trusts and Estates.—(Section 421(c) of the Revenue Act of 1978 and section 58(c) of the Code.)

The Revenue Act of 1978 imposed a new alternative minimum tax on individuals including trusts and estates. In the case of a trust or estate, items of tax preference are to be apportioned between the estate or trust and the beneficiaries on the basis of income of the estate or trust allocable to each. This rule does not work well in the case of the preference for adjusted itemized deductions. The proposed amendment would provide that the allocation of items of tax preference would be made in accordance with Treasury regulations.

Recapture of Depreciation of Certain Subsidized Low-Income Housing.—(Section 701(f)(3)(E) of the Revenue Act of 1978 and section 1250(a)(1)(B) of the Code.)

The Revenue Act of 1978 added a provision to clarify that in computing the depreciation recapture under section 1250 of the Code for property on which rehabilitation expenditures were amortized under Code section 191, the amount of "straight line" depreciation is to be computed without regard to the 5-year useful life under section 191. This amendment may inadvertently have caused additional recapture to apply to certain subsidized low-income housing. The proposed amendment would negate this inadvertent impact by providing that subsidized low-income housing remains eligible for the special phase-out of recapture even though rehabilitation expenditures for that housing have been amortized under Code section 191.

Employee of Grantor or Beneficiary Treated as Related Person for Purposes of the Tax on Generation Skipping Transfers.—(Section 702(n)(2) of the Revenue Act of 1978 and section 2613(e) of the Code.)

Under the generation skipping provisions, an individual is a beneficiary of a trust if he has a present or future power or interest in it. "Power" means "any power to establish or alter beneficial enjoyment of the corpus or income of the trust." A person has an "interest" if the person has either "a right to receive income or corpus from the trust" or "is a permissible recipient of such income or corpus." Thus, one can be a beneficiary by satisfying either or both of the tests.

The Tax Reform Act of 1976 excluded certain independent trustees from being treated as beneficiaries solely because of powers which they held to distribute trust corpus and income. The original language in section 2613(e) was found too restrictive and section 702(n)(2) of the Revenue Act of 1978 expanded the categories of individuals to whom independent trustees could make distributions without being treated as beneficiaries.

The 1978 Act excluded from the independent trustees any person who is an employee of a corporation in which the stockholdings of the grantor, the trust, and the beneficiaries of the trust are significant from the viewpoint of voting control, an employee of a corporation in which the grantor or any beneficiary of a trust is an executive, an employees of a corporation in which the grantor or any beneficiary of the trust is an executive, and an employee of a partnership in which the grantor or any beneficiary of the trust is a partner. However, the provision did not exclude a person who is directly employed by the grantor or any beneficiary of the trust. The proposed amendment would exclude an employee of the grantor or any beneficiary of the trust from being an independent trustee.

Certain Powers of Independent Trustees Not Treated as a Power for Purposes of the Tax on Generation-Skipping Transfers.—(Section 702(n)(2) of the Revenue Act of 1978 and section 2613(e) of the Code.)

Under the generation-skipping provisions, an individual is a beneficiary of a trust if he has a present or future power or interest in it. "Power" means "any power to establish or alter beneficial enjoyment of the corpus or income of the trust." A person has an "interest" if the person has either "a right to receive income or corpus from the trust" or "is a permissible recipient of such income or corpus." Thus, one can be a beneficiary by satisfying either or both of the tests.

The Tax Reform Act of 1976 excluded certain independent trustees from being treated as beneficiaries solely because of powers which they held to distribute trust corpus and income. The original language in section 2613(e) was found too restrictive and section 702(n)(2) of the Revenue Act of 1978 expanded the categories of individuals to whom independent trustees could make distributions without being treated as beneficiaries.

The statute presently provides that an individual will not be treated as having a power if such an individual "is a trustee who has no *interest* in the trust" (emphasis added). Thus, an individual trustee who was the permissible appointee of trust assets under an unexercised power of appointment held by another would be deemed to have an interest in the trust and would therefore be treated as having a

power over the trust. The trustee would be a beneficiary of the trust and the independent trustee exemption would be negated.

The legislative history of the Revenue Act of 1978 states that an individual trustee will not be treated as a beneficiary if "he has no interest in the trust other than as a potential appointee under a power of appointment held by another." The proposed amendment would adopt this result by providing that, solely for purposes of the independent trustee exemption, a trustee will not be treated as having an interest in the trust if his only interest is as a permissible appointee under an unexercised power of appointment held by another.

Correction of Cross Reference.—(Section 4(d)(7) of Public Law 95-227 and section 7454(b) of the Code.)

The cross reference in section 7454(b) of the Code to section 502(c)(21) would be corrected to section 501(c)(21).

Correction of Cross References in Code Section 401(a)(20).—(Section 4 of Public Law 95-458.)

Public Law 95-458 amended Code sections 402(a)(5) and 403(a)(4). Code section 401(a)(20) includes cross references to sections 402(a)(5) and 403(a)(4), but these cross references were not amended to reflect the changes made by Public Law 95-458. The proposed amendment would correct the cross references to reflect these changes.

Security for Recapture of Estate Tax Reduction From Farm Valuation Where Property Had Been Involuntarily Converted.—(Section 4 of Public Law 95-472 and section 6324B(c) of the Code.)

The Tax Reform Act of 1976 provided that certain property used for farming or in a closely held business may be valued for estate tax purposes at its current use value instead of its highest and best use value. However, if the property is disposed of within a 15-year period all or part of the estate tax benefit is recaptures. A lien is placed on the property for the amount of the recapture tax. Section 4 of Public Law 95-472 provides that if an involuntary conversion of qualified real property takes place, no recapture of the estate tax benefit will occur if the property is replaced by other real property of at least equal value acquired for the same use. However, the property acquired in the involuntary conversion may be more highly leveraged so that the lien on the equity interest is insufficient for the recapture of tax benefits. The proposed amendment would provide that, if at any time the value of the property subject to the lien is less than the amount of the potential recapture tax, the Treasury Department may require the addition of additional property subject to the lien or other security (such as a bond) which would bring the total amount of the security up to the amount of the potential recapture tax.

Senator BYRD. The next witness will be Mr. Lipman Redman, of the tax section of the American Bar Association

I might say I am very glad to see my neighbor here today.

STATEMENT OF LIPMAN REDMAN, TAX SECTION, AMERICAN BAR ASSOCIATION

Mr. REDMAN. Thank you, Mr. Chairman. I apologize for not having been here, there was a mixup in my signals, I apologize for that.

Senator BYRD. No, it is not your fault it was the Chair's fault. How was your trip to China?

Mr. REDMAN. It was very fine, thank you, sir. I found there was not much tax business for a lawyer in China so I decided to come home but it was a very exciting trip.

Mr. Chairman, you have heard me say before when you have chaired hearings of this type, I must disclaim that I speak on behalf of the American Bar Association or even of the tax section even though the views I am expressing are those which represent the considered thoughts of a number of individual members of the section, including its chairman, Charles Walker who could not be here today and the members of its council.

The discussion I heard this afternoon since I arrived in the hearing room helps prove the basic point I would like to try to

make. I am distressed at the need to have to make it and it may well be that I am about to tread where angels have feared to go but I have never been accused before of being an angel.

The thrust at the House committee hearings on this bill in which many of the witnesses .ncluding Treasury participated and shared was to the effect that let's get a technical corrections bill passed as soon as possible. That was the end of March. Here we are early in November and we still don't have a bill. I am fully aware of the fact that the subcommittee and the committee and the Congress have a great many things to do but the more we delay and the more we attempt to perfect this bill, the longer it is going to take to get a bill and the greater the exposure to ending up in controversy similar to what happened to the technical corrections bill on the 1976 act.

This bill before the committee today may not be the best technical corrections bill. Indeed, the tax section committees have submitted this file of comments [pointing] before the House acted on 2797 and we submitted this batch of comments [pointing] on the bill after it was enacted. The result is that a lot of our thoughts are not contained in the bill and a lot of our thoughts we think ought to be the subject of a technical corrections bill but we would rather see a bill even though it does not contain everything we want and worry about getting other changes on a second bite at the apple rather than further delay the enactment of a bill.

I think it is very important to show the world and the tax community that when a tax bill is enacted the way the 1978 act was enacted so there is clearly a need for technical corrections, there ought to be a bill with required corrections as soon as possible. As I say, the bill is not perfect and it is not complete. We think it is a good bill, we think it ought to be enacted. The Treasury 45 page statement today which obviously none of us has seen may well contain nothing but required corrections of a noncontroversial nature but if they are to be considered by this committee and it goes to the Senate in that fashion, there is going to have to be a conference whereas hopefully—maybe I am dreaming—hopefully if this committee will approve 2797 as it passed the House, the Senate hopefully will pass it, there will be no need for a conference, at least we will show the world that there is a way in the space of less than a year or about a year to get a technical corrections bill. So everything else aside, I am Redman against everything in the 45 page statement even though on their merits I might agree with every one of them.

So our main thrust, my main thrust today is let's get a bill passed, not perfect, not complete, but let's get it passed in its presents form.

Senator BYRD. What you say has a good deal of appeal to the Chair. I think the committee is prepared to act almost immediately on the House passed proposal but I, for one, would hesitate to take a 45 page proposal and say we will add that to it and forget about it and go ahead and pass it. I think the public is entitled to have some input if indeed there is anything in there that they should have input on or would want to have input on.

Mr. REDMAN. I want to also emphasize that I may have no problem with any of the things in those 45 pages and my comment

extends to a number of the other proposals that are being submitted to the committee today and at other times; they may well be full of merit, they may well be noncontroversial, but it is going to take time to process them and consider them and when does the process stop?

Senator BYRD. Your thinking is that the country, everyone would be better off to go ahead with the House-passed bill, have the Senate, if it is willing to do so, enact it in the form in which it passed the House and then start a new technical corrections bill next year, say, is that correct?

Mr. REDMAN. That is correct. I am not sure I would say the country is better off one way or the other, but I think in the tax community it is a good way to go.

Senator BYRD. But from the point of view of those involved in the tax laws, it would be better to get the House-passed bill through the Senate now, without amendments, rather than to attempt to perfect what the House has done and to add other proposals which you yourself or the tax section itself recommends be done at some future date, is that it?

Mr. REDMAN. That is what Redman is proposing, yes, sir.

Senator BYRD. Thank you very much.

Mr. REDMAN. Mr. Chairman, glad to be here.

Senator BYRD. I assume that you will look over these 45 pages and give the committee the benefit of your judgment.

Mr. REDMAN. We certainly will.

Senator BYRD. Thank you.

Mr. REDMAN. Yes, sir.

Senator BYRD. The next witness will be a panel consisting of Mr. William J. Lehrfeld, Shriner's Hospitals for Crippled Children; Mr. Charles L. Boothby, National Association of Conservation Districts; and Mr. Robert Skinner, Western Association of Equipment Lessors.

Welcome, gentlemen. You may proceed.

STATEMENT OF WILLIAM J. LEHRFELD, SHRINER'S HOSPITALS FOR CRIPPLED CHILDREN

Mr. LEHRFELD. Mr. Chairman, my name is William J. Lehrfeld and I serve as counsel for the Shriner's Hospitals for Crippled Children which is a charitable institution providing free hospital care for crippled and burned children in the United States. It is the last free such institution in this country, save for Government hospitals.

As a personal aside, Mr. Chairman, I am a member of the tax section of the American Bar Association which Mr. Redman chairs. I have served on its Nominating Committee and have chaired its Exempt Organizations Committee. I would like to take strong issue with Mr. Lipman Redman's desire for haste in the technical correction process because it creates the same unfortunate situation that created the need for the Technical Corrections Act itself. Legislation that is considered in haste and which is passed in haste requires corrections. If you are going to have an extremely short correction period, you are again not going to provide the kind of thoughtfulness that the process requires to assure that the original intent of Congress is carried forward through corrections.

Senator BYRD. Let me ask you at this point now. Are you speaking now of the 45 page attachment?

Mr. LEHRFELD. I am speaking of the general observation that Mr. Redman had about the need to pass quickly, a corrections act. I think the need for corrections is not so great that it demands the haste Mr. Redman desires. Thoughtfulness is needed so the purposes of Congress in all of the 1978 legislation is carried out. This committee should hold its independent hearings since it is an independent body of the Congress itself and makes independent judgments on the needs for technical corrections.

Senator BYRD. Let me ask you about the House passed bill. Do you have any problem with that?

Mr. LEHRFELD. No, none whatsoever.

Senator BYRD. So you would favor that as passed by the House?

Mr. LEHRFELD. Certainly.

Senator BYRD. I think that has been well deliberated.

Mr. LEHRFELD. Absolutely. Perhaps our plight should be reorganized, and that is why your subcommittee is making these hearings available now and will make substantive decisions concerning suggestions made by, among others, this panel. I would be very concerned that the legislative process be expedited simply because of an allegation that the public needs justify merely a one sided set of technical corrections which was prepared by the other body.

Senator BYRD. What length of time do you think would be appropriate to have the new matter under consideration?

Mr. LEHRFELD. I would say there is an availability of some 2 to 6 weeks that would be more than adequate for this committee to receive comments, for the staff to evaluate them, to make presentations to the subcommittee members, have a markup and refer it to the entire committee. The substantive corrections I have deal with amendments to section 514 of the Revenue Act of 1978 dealing with charitable remainders. As I indicated earlier, continuity and consistency between transitional rules is very helpful in the administration of the previous laws. The rules on deferred charitable giving are extremely complex and in 1978 a third transitional rule was enacted which did not for continuity purposes contain the same rules in the 1976 act; namely section 514 of the 1978 act had no effective date and second it had no opportunity for otherwise barred claims to be reopened because the statute of limitation had passed, as existed in section 1304 of the 1976 act. We would suggest that section 514 of the 1978 act contain an effective date consistent with the changes made to the rules governing charitable remainder trusts that was effective for the 1974 law and for the 1976 law. I don't believe there is any objection on anybody's part to assure this continuity.

We would also suggest that the provision in the 1976 act, section 1304(b), dealing with the opportunity to open up otherwise barred claims because the statute of limitation had expired also be added to section 514. I doubt that there would be very much revenue loss caused by this reopening of these closed years because all events have transpired thus far to determine whether a right to a refund exists. In other words, the right to refund had to exist on December 31, 1978, and if it did not exist then there is no adequate remedy

for an effected charity. So you are not giving charities anything that was not given December 31, 1978.

Senator BYRD. Thank you.

Would the Treasury care to comment on that proposal?

Mr. FERGUSON. Mr. Chairman, at this point the only comment I would like to make is that amendments relating to the 1976 act—as opposed to the 1978 act—would seem to be beyond the scope of the House-passed bill. Of course, this committee is free to expand the scope if it chooses, but I believe there is a strong argument for trying to keep the bill confined to corrections of 1978 legislation. If I understood the testimony, there was one amendment related to the 1978 act. I cannot comment on that now; we will look at it. One amendment may relate to the 1976 act. I think that, regardless of the merits, there should be a presumption—maybe an irrebuttable presumption—that opening up the 1976 legislation is just beyond the scope of this bill.

Senator BYRD. It has been the view and purpose of the committee to confine its deliberations on this matter to the 1978 act so I think the Treasury raises a point that needs to be considered.

Mr. LEHRFELD. I understand that, Mr. Chairman.

[The prepared statement of Mr. Lehrfeld follows:]

SUMMARY OF STATEMENT OF SHRINERS HOSPITALS FOR CRIPPLED CHILDREN TAMPA, FLA.

The Tax Reform Act of 1969 enacted Sec. 2055(e)(2) to bar an estate tax charitable deduction for the value of a remainder passing to charity unless it passes to a charitable remainder unitrust, charitable remainder annuity trust or a pooled income fund. From the very beginning, these provisions were found to be extremely complex and frequently resulted in lost charitable deductions because testamentary trusts were not being drawn to meet the very exacting standards of IRS implementing regulations. In 1974, Congress permitted executors, private beneficiaries and charitable institutions to reform wills and other testamentary instruments containing unqualified charitable remainder bequests to enable estates to obtain an estate tax charitable deduction if the revised trust complied with Sec. 2055(e)(2). This initiai provision (Sec. 2055(e)(3)) expired on December 31, 1975, but was revived in 1976 (expiring December 31, 1977) and again in 1978 (expiring December 31, 1978). In the 1974 and 1976 legislation, Congress provided effective dates for the application of the relief, viz, estates of decedent's dying after December 31, 1969. In 1978, a similar effective date provision was omitted, perhaps inadvertently, in enacting the final relief extension. An effective date should be added to the 1978 law assuring that, with respect to the last extension, it is also effective for decedent's dying after December 31, 1969.

When Congress extended the relief in 1976, it also permitted estates to retroactively file refund claims for reformations even though the three year statute of limitations, as prescribed by Sec. 6511, would otherwise bar a refund. A similar provision was omitted, perhaps inadvertently, in connection with the 1978 extension. The 1978 extension should be amended to provide for the same relief to barred claims that was provided to such claims by the 1976 extension. The extension for barred claims should be available to June 30, 1978.

WITNESS STATEMENT OF SHRINERS HOSPITALS FOR CRIPPLED CHILDREN

Under present law, deferred giving to charity is discouraged because of the complex rules dealing with charitable remainder trusts. Deferred giving is a means by which a donor, with perhaps his or her spouse, may make a present gift to charity of a remainder interest in property and retain the use of the property (such as a residence or farm) or the income from the property for their lifetimes. Upon their death, the property usually passes free of trust to the charities. In 1969, Congress misperceived alleged abuses in deferred giving and wrote stringent rules limiting the ability of donors to use deferred giving as a means of encouraging the philanthropy of their choice. By enacting such provisions of law such as Sec.

2055(e)(2), and Sec. 664, requiring donors to give property to charitable remainder annuity trusts or charitable remainder unitrusts, the Congress has encouraged the Internal Revenue Service to create a maze of difficult, intricate, inconsistent and improvident rules governing this form of deferred giving.

Partly in recognition of the unfortunate incidents that these limitations on giving created, the Treasury Department, on its own initiative, permitted executors of estates to reform or amend trusts created under wills, or inter vivos trusts, in order to assure that the trusts which had been written wrongly, were in the proper format as to allow a deduction. The Shriners Hospitals for Crippled Children, with other charities, encouraged the Congress to enact into law similar reformation relief after the Treasury Department's reformation period expired on December 31, 1972. This Congress did in 1974 by enacting Sec. 2055(e)(3) with the right of reformation extended to December 31, 1975. The reformation date was twice extended by Congress in recognition of the great difficulties created by the existence of Sec. 664 and Sec. 2055(e)(2).

In 1976, The Tax Reform Act of 1976, permitted estates to file refund claims in connection with reformations of charitable remainder trusts even though the time for filing a claim had expired under Sec. 6511 (the general statute dealing with statute of limitations for refund claims). See Sec. 1304 of 1976 Act. This was done in recognition of the fact that the time for reforming a trust granted to executors, charities and the private beneficiaries, was not very long to permit effective use of the 1974 and 1976 relief provisions. Thus, by opening up otherwise closed periods, the Congress encouraged reformations permitting more funds to flow to charity. More funds flowed to charity upon reformation because the tax refund that is permitted becomes part of the corpus of the charitable remainder trust and eventually passes to charity after the private interests expire.

In 1978, the Congress permitted reformations to take into account the fact that under certain circumstances the charities would not only have a remainder interest in trust, but also an income interest in trust. By enacting Sec. 514 of the Revenue Act of 1978, the Congress encouraged reformation of trusts giving the charities a current interest in the income of the remainder trust along with a current interest in the reformed remainder. Regrettably, Sec. 514 did not carry with it an effective date. We have now experienced the fact that, in at least one district, estate tax examiners are taking the position that Sec. 514, without an effective date, is effective only upon date of enactment of the Revenue Act of 1978, November 6, 1978. Thus, it is the position of this district that trusts may only be reformed, to provide for a charitable income interest, from the period of November 6, 1978, through December 31, 1978. We do not believe the Congress intended sec. 514 not to be coterminously effective with the effective date of Sec. 2055(e)(3) itself. Sec. 2055(e)(3), when originally enacted, was effective for decedent's dying after December 31, 1969. The 1976 changes also had an effective date of decedent's dying after December 31, 1969. See, Sec. 1304(c) of the 1976 Act. Accordingly, Sec. 514 of the Revenue Act of 1978 should be amended to add a provision, such as subparagraph (c), which simply provides that the provision is retroactive in effect to decedent's dying after December 31, 1969.

Next, we also believe that a provision like Sec. 1304(b) of the Tax Reform Act of 1976 be added to Sec. 514 of the 1978 Act to permit otherwise expired claims, dealing, for example, with a reformed income interest, to be filed by decedent's estate up to June 30, 1980. By permitting trusts which have already been reformed, pursuant to judicial decree, or which have been deemed to be reformed because of the decedent's death before December 31, 1978 and the death of the life income beneficiary prior to the filing of the federal estate tax return, Congress would be granting these estates a charitable contribution deduction for the value of the reformed income interest which is passing to charity which today is barred by Sec. 6511.

These two suggested amendments to Sec. 514 are extremely limited in scope and are meant simply to clarify existing law and provide a tax benefit to otherwise barred claims where the income interest was reformed, but no deduction was allowable at the time of reformation for income interest passing to charity since Sec. 514 was not enacted until November of 1978.

Shriners Hospitals for Crippled Children wants to be on record that Sec. 2055(e)(2), and corresponding provisions of the income tax laws (Sec. 170(e)(2)) and gift tax laws (Sec. 2522(c)(2)) are a considerable impediment to charitable giving. If the Congress believes that there is inadequate evidence to justify repeal of these two provisions, we believe that the right of reformation for unqualified trusts should be a permanent part of the law. We wish to make it very plain that Sec. 2055(e)(2) and Sec. 664, requiring complex annuity trusts or unitrusts have not benefited the

charities as they were purportedly intended to do, but have simply caused them to lose many gifts. Gifts are lost due to donor confusion and fright and wonderment over whether the estate will obtain the deduction. Repeal of Sec. 2055(e)(2), for example, would not harm charities because the charity's interest in trust would be protected by the private foundation excise taxes which are imposed upon these charitable remainder trusts as part of the regulatory scheme which Congress enacted in 1969. We hope this Subcommittee will later concern itself with methods which encourage deferred giving and not thwart the interests of many charitable inclined individuals who feel that present law is simply too rigid and complex.

Thank you for your attention.

Senator BYRD. The next witness is Mr. Charles L. Boothby, National Association of Conservation Districts.

STATEMENT OF CHARLES L. BOOTHBY, EXECUTIVE SECRETARY, NATIONAL ASSOCIATION OF CONSERVATION DISTRICTS

Mr. BOOTHBY. Mr. Chairman, members of the committee, I am Charles L. Boothby, executive secretary, National Association of Conservation Districts. NACD, as we are commonly called, represents the 2,950 conservation districts, their 52 State associations—includes Puerto Rico and the Virgin Islands—and the 17,000 locally elected and appointed public officials who administer them. Conservation districts are legal subdivisions of State government, organized to develop and carry out programs of soil and water conservation at the local level. They serve the needs of over 2.5 million cooperating landowners.

Section 543 of the Revenue Act of 1978 added section 126 to part III of subchapter B of chapter 1 of the Internal Revenue Code of 1954. This section exempts from gross income those payments made by Federal and State governments in cost-shares for the installation of conservation measures on the land. It includes payments made under nine Federal cost-share programs and any State program under which payments are made to individuals primarily for the purpose of conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife. This same act adds a new section 1255, Gain From Disposition of Section 126 Property.

It has been brought to our attention that many persons contemplating the utilization of section 126 have real reservations about doing so because of section 1255. Section 1255 is perceived as placing an untenable lien against the property and vastly increasing the necessary recordkeeping. People are concerned about being able to show the exact increase in value of the property directly resulting from the application of conservation practices. Further, many times conservation practices may reduce the amount of land on the farm available for crop production. This is true of diversions, terraces, sod waterways, filter strips, and similar practices.

Paragraph 3 of section 1255 provides for a 100-percent rollback for the first 10 years and then a decreasing rollback over the second 10 years. Most conservation practices applied to cropland have a design useful life of only 10 years. Therefore, this provision really places a burden on the landowner and will undoubtedly discourage him from utilizing the advantages provided by section 126.

Section 126, as previously stated, excludes from gross income payments made by Federal and State governments for the purpose

of sharing the costs of installing conservation and environmental measures. It does not, however, exclude such payments made by substate units of government made for the same purpose.

In many States, substate units of government such as counties, conservation districts, and natural resource districts have appropriated funds for cost-sharing with landowners for the installation of conservation practices. Additionally, substate units of government have served as conduits for State cost-sharing funds. This has caused some confusion and has prompted many States to seek clarification of the issue of substate cost-sharing.

The purpose of section 126 is to encourage landowners to install conservation practices. As presently written, section 126 tends to discourage substate units of government from becoming involved financially in conservation programs. We recommend that section 126(a)(10) be amended to read:

(10) Any [state] program *authorized by, a state, a territory, or a possession of the United States or any political subdivision of any of the foregoing, or of the District of Columbia* under which payments are made to individuals primarily for the purpose of conserving soil, protecting or restoring the environment, improving forests or providing a habitat for wildlife.

We have enclosed copies of letters from various States which support this proposal.

Thank you for this opportunity to express the views of our association on this matter.

[The letters referred to follow:]

MISSOURI SOIL AND WATER DISTRICTS COMMISSION,
September 13, 1979.

Dr. ARNOLD MILLER,
Administration Building,
U.S. Department of Agriculture, Washington, D.C.

DEAR SIR: The Missouri Soil and Water Districts Commission has reviewed the proposed rules for implementing the Revenue Act of 1978; Determining the Primary Purpose of Certain Federal and State Payments. We believe the proposed rules are consistent with the objective of encouraging private landowners to participate in voluntary conservation cost-share programs that will provide environmental benefits to the public.

The Commission is currently developing a state soil and water conservation cost-sharing program. During the development process we have tried to maintain a compatibility with similar programs from other levels of government. Cost-share programs from the different levels of government need to be complimentary not competitive. For this reason, we were pleased to note that state cost-sharing programs were included in the proposed rules. We believe it is equally important to include any sub-state entity that develops a cost-share program in the proposed rules. A cost-share program that is excluded from this important tax incentive probably would not survive.

The Missouri Soil and Water Districts Commission recommends the proposed rules to implement the Revenue Act of 1978 be expanded to include county funded programs.

Sincerely,

BETTY BROEMMELSIEK,
Chairman.

STATE OF NEW JERSEY,
DEPARTMENT OF AGRICULTURE,
Trenton, N.J., September 7, 1979.

Dr. ARNOLD MILLER,
Office of Budget Planning and Evaluation, Office of the Secretary, Administration Building, U.S. Department of Agriculture, Washington, D.C.

DEAR DR. MILLER: Copies of the proposed rules to implement the Revenue Act of 1978 in determining the primary purpose of certain federal and state payments for conservation purposes has been received at this office. The definition of those payments which qualify for exemption from taxation appears to be limited to funds received from states and does not include funds which may be received from substate entities. While in New Jersey at the present time there are no State or substate agency payments of this nature, it would seem appropriate to also include payments which may be made for conservation purposes by substate entities.

This comment is forwarded in behalf of the New Jersey State Soil Conservation Committee.

Sincerely,

SAMUEL R. RACE.

MINNESOTA SOIL AND WATER CONSERVATION BOARD,
DEPARTMENT OF NATURAL RESOURCES,
St. Paul, Minn., September 14, 1979.

Dr. ARNOLD MILLER,
Office of Budget, Planning and Evaluation, Office of the Secretary, U.S. Department of Agriculture, Administration Building, Washington, D.C.

DEAR MR. MILLER: I am writing with reference to the proposed rule for implementing the Revenue Act of 1978 determining the primary purposes of certain federal and state payments.

The State of Minnesota provides payments to landowners for cost sharing purposes in excess of 1.5 million dollars annually plus county government contributions in excess of 1 million dollars for District operations. In addition to this Soil and Water Conservation Districts provide just short of 1 million dollars as contributions to Soil and Water Conservation Districts programs. With this in mind, I refer particularly to Section 14.6(a) on page 49273 of the Federal Register, Vol. 44, No. 164, dated Wednesday, August 22, 1979. It is my opinion that the definition of state programs should include programs funded by sub-units of state government such as counties, watershed districts, sanitary districts, etc. At the present time, local funds contributed for soil erosion control purposes cannot be considered as an exemption. This will certainly discourage local government input into conservation cost sharing programs.

Sincerely,

VERNON F. REINERT,
Executive Director.

OHIO DEPARTMENT OF NATURAL RESOURCES,
DIVISION OF SOIL AND WATER DISTRICTS,
Columbus, Ohio, September 13, 1979.

Dr. ARNOLD MILLER,
Office of Budget, Planning and Evaluation, Office of the Secretary, Administration Building, U.S. Department of Agriculture, Washington, D.C.

DEAR DR. MILLER: We wish to register the following recommendations pertaining to the Federal Register Vol. 44 No. 164 dated Wednesday, August 22, 1979 setting forth proposed rules by the Department of Agriculture (7 CFR Part 14) for implementing the Revenue Act of 1978; determining the primary purpose of certain federal and state payments:

1. The proposed rules should reflect exemption of payments received by an owner of land for installing conservation and pollution abatement practics regardless of the public fund source. The rules now reflect state and federal funding but fail to allow exemption of county or any other local source of appropriated funds for such purposes.
2. We feel strongly that the Revenue Act of 1978 should be interpreted to include animal waste pollution abatement practices. Should the proposed rules be interpreted to include animal waste pollution abatement practices under the language "Pro-

tecting or restoring the environment" no further identity is necessary. Should the opposite opinion prevail, amendment to include animal waste practices should be inserted.

Enclosed is a copy of Section 1515.30 of the Ohio Revised Code setting forth the provision for cost share payments and the adoption of state rules relating to the same. A copy of the state adopted cost share rules relating to both agricultural sediment and animal waste pollution abatement practices is enclosed for your review.

We trust these comments and supporting documents will be helpful in your final determinations. Should further information be helpful, please request the same.

Sincerely,

FLOYD E. HEFT, *Chief.*

NEBRASKA NATURAL RESOURCES COMMISSION,
Lincoln, Nebr., July 11, 1979.

Dr. ARNOLD MILLER,
Office of Budget, Planning and Evaluation, Office of the Secretary, Administration Building, U.S. Department of Agriculture, Washington, D.C.

DEAR DR. MILLIER: Enclosed are six copies of the information requested in the June 29, 1979 Federal Register was not received by our agency or the law library therefore, our reaction time regarding the federal income tax exclusion for state cost share program payments. I hope our "Nebraska Water Conservation Program Procedures Handbook" contains all the information you require.

In accordance with your suggestion made to our Assistant Legal Counsel, Jay Holmquist, over the telephone on Monday, we are advising all of the state's Natural Resources Districts to provide you with similar information regarding their locally funded cost share programs in the hope that these programs will also be eligible for the income tax exclusion. Their information will not reach you by the 15th of this month, however, I have encouraged them to send it as quickly as possible. Part I of the Friday, June 29, 1979 Federal Register was not received by our agency or the law library, therefore, our recreation time was rather short. We were not made aware of exactly what was required until July 9 when we received a copy of the notice from Charles Boothby of the NACD.

We would make one comment regarding the implementation of section 543. Locally funded programs for cost share assistance such as those carried on by our Natural Resources Districts should be eligible for the income tax exclusion. Although not all of Nebraska's NRDs carry on these programs, those that do contributed over $900,000 in local funds for cost sharing on practices for conservation, wildlife habitat and environmental protection. This is considerably more than has been appropriated by the Legislature for the Nebraska Water Conservation Program. The purpose of these programs is largely to supplement the limited federal funds available for conservation practices and they make a very important contribution to the conservation and protection of Nebraska's natural resources and wildlife. The availability of this income tax exclusion would serve as an incentive for landowners to cooperate in the local programs and so we would strongly recommend that "state programs" be defined to include any non-federal program for cost share assistance.

Thank you for the opportunity to present our comments. If your have any questions or require additional information feel free to contact me.

Sincerely yours,

DAYLE E. WILLIAMSON,
Executive Secretary.

Enclosure.

STATE OF WISCONSIN,
OFFICE OF THE GOVERNOR,
Madison, Wis., September 27, 1979.

Dr. ARNOLD MILLER,
Office of Budget, Planning and Evaluation, Office of the Secretary, Administrative Building, U.S. Department of Agriculture, Washington, D.C.

DEAR DR. MILLER: This letter is in reply to Secretary Bergland's request for information concerning Wisconsin programs that allocate state or federal funds to private individuals for conservation, environmental protection, forestry or wildlife habitat purposes. Secretary Bergland's correspondence indicates that payments made to individuals under such programs are exempt from federal taxes under Section 543 of the Revenue Act of 1978 (Public Law 95-600).

The State of Wisconsin funds two programs which appear to meet Section 543 requirements. The Wisconsin Fund supports point and non-point source pollution abatement and solid waste management programs. The fund, which is administered by the Wisconsin Department of Natural Resources, provides cost-sharing monies to individuals for certain pollution control practices and structures.

The second Wisconsin program which may be eligible for the tax exemption is our farmland preservation program. The Wisconsin Farmland Preservation Program provides circuitbreaker tax relief (an income tax credit *or* refund) to individuals and local governments who take action to preserve agricultural land. Soil conservation and local land use planning and regulation to preserve farmland and open space are all encouraged under the program. Farmland preservation contracts require soil and water conservation measures. The farmland preservation tax credit appears to meet criteria for federal tax exemption established under sec. 126(b) (1) and (2) of the 1978 Revenue Act, since credits are available only to those who protect the environment by preserving their soil and farmland.

I am submitting six copies each of various printed materials on the Wisconsin Fund and the Farmland Preservation Program, as requested in Secretary Bergland's original correspondence.

For the Wisconsin fund, these materials include: (1) Enabling legislation; (2) Administrative rules; (3) "Guidelines for Non-Point Source Water Pollution Abatement Program: A Part of the Wisconsin Fund"; and (4) "Handbook on Cost-Sharing for Best Management Practices".

For additional information on the Wisconsin Fund, contact: Mr. John Konrad, Chief of Special Studies, Bureau of Water Quality, Wisconsin Department of Natural Resources, 2825 University Avenue, Madison, WI 53707, (608) 266-1956.

The farmland preservation materials include: (1) Enabling legislation; (2) Informational borchure; (3) Samples of farmland preservation contracts; (4) Copies of Wisconsin state income tax schedule FC (Farmland Credit); and (5) Local planning and zoning standards established by the state program.

For additional information on the Farmland Preservation Program, please contact: Mr. Jim Johnson, Director, Farmland Preservation Program, Wisconsin Department of Agriculture, Trade and Consumer Protection, 801 West Badger Road, Madison, WI 53708, (608) 266-9819.

In addition to these state-funded programs, there are between nine and eleven Wisconsin counties which administer their own cost-sharing programs through local Soil and Water Conservation Districts. Funds for county programs come from county general revenues. Levels of cost sharing vary depending on local priorities and the nature of the practice to be installed.

I bring these county initiatives to your attention in response to the call for comments regarding the inclusion of sub-state programs in the definition of state programs for purposes of Section 543 of the 1978 Revenue Act. (proposed rule implementing the Revenue Act of 1978, etc., Supplementary Information: (4) State programs). From a public policy standpoint, Wisconsin's sub-state programs contribute significantly to soil conservation in certain critical areas of the state. Because they do, and because the local cost-share programs are very similar to state and federal efforts, I strongly urge the Department of Agriculture to give favorable tax exemption consideration to sub-state programs. More information on the county soil conservation cost-sharing programs can be obtained from Mr. Leonard Johnson, Wisconsin Board of Soil and Water Conservation Districts, 1815 University Avenue, Madison, Wisconsin 53706. Mr. Johnson's phone number is (608) 266-8755.

The State of Wisconsin appreciates your consideration of the Wisconsin Fund, the Farmland Preservation Program, and the various county cost-sharing programs for tax exemptions under the revised revenue code. If we can be of further assistance in your evaluation of these programs, please do not hesitate to contact the Governor's Office or any of the people listed above.

Sincerely,

LEE SHERMAN DREYFUS,
Governor.

LOWER LOUP NATURAL RESOURCES DISTRICT,
Ord, Nebr., July 16, 1979.

DR. ARNOLD MILLER,
Office of Budget Planning and Evaluation,
Administration Building, USDA, Washington, D.C.

DEAR DR. MILLER: In reply to a request from Dayle Williamson, Executive Secretary of the Nebraska Natural Resources Commission, we are forwarding for your

review, information on those cost-sharing plans whereby the Lower Loup Natural Resources District makes payment to landowners within the District. Our purpose in submitting this information is to assist you in making a determination of whether or not these payments made by the District qualify under Section 543 of the Revenue Act of 1978.

Presently the District provides direct cost-share assistance utilizing District funds to landowners under two programs. Funds provided under the Wildlife Habitat Improvement Program are a joint venture between the Nebraska Game & Parks Commission and the Lower Loup Natural Resources District on a 75% Game & Parks—25% Lower Loup NRD funding. The Game & Parks funds are derived directly from that state agency; the District funds are derived from a local tax levy.

The funds are paid to landowners as compensation for dedicating certain acres to wildlife habitat; for diverting grassland to wildlife habitat; for establishment of permanent and temporary vegetative cover; and for construction of fence to exclude livestock from those areas set aside for wildlife habitat. Game & Parks' authority for this type of involvement under state law comes from Section 37-109, R.R.S., Nebraska 1943.

The other program that the District is involved in amounts to cost-sharing with local landowners for establishing farmstead windbreaks and livestock shelterbelts. This practice involves the planting of trees; construction of fence; and maintenance of these plantings for wind protection. The District's authority to be involved in this type of practice is found in Nebraska Statutes Sections 2-3235, R.R.S., Nebraska 1943.

The Lower Loup NRD is a political subdivision of the State of Nebraska, established by the Nebraska Legislature under Sections 2-3201 to 2-3261, R.R.S., Nebraska 1943. We believe that revenue from the above mentioned sources should provide recipients with an exclusion of certain payments from gross income, as alluded to in the Federal Register Volume 44, No. 127, Friday, June 29, 1979, pages 37953 and 37954.

For your information, we are supplying you with reprints of Sections 2-3229 which spell out the purpose of Natural Resources Districts (you would be most specifically interested in purposes (10) and (12)) and Section 3235, which sets forth the Districts' authority to cooperate and furnish financial and other aid to cooperators, agencies, etc.

I sincerely hope the above cited information will assist you in making a determination on this exclusion.

Sincerely,

RICHARD J. BERAN,
General Manager.

Enclosure.

NEBRASKA NATURAL RESOURCES COMMISSION,
Lincoln, Nebr., July 24, 1979.

Dr. ARNOLD MILLER,
Office of Budget, Planning and Evaluation, Office of the Secretary, Administration Building, U.S. Department of Agriculture, Washington, D.C.

DEAR DR. MILLER: Enclosed are six copies of the information on the Lower Republican Natural Resources District's cost-share programs which were mistakenly sent to our office. Although it does not contain all the information requested in order for your office to consider whether the local program should be eligible for the section 543 income tax exclusion, I felt it should be transmitted for your consideration since it does adequately describe the purpose of the programs.

I would like to take this opportunity to once again urge that section 543 be implemented to include local cost-share programs of the kind carried on by Nebraska's natural resources districts. They play a very important role in this state's efforts to reduce agricultural related pollution, improve conservation and provide wildlife habitat and are deserving of favorable tax treatment.

Sincerely yours,

DAYLE E. WILLIAMSON,
Executive Secretary.

IOWA DEPARTMENT OF SOIL CONSERVATION,
Des Moines, Iowa, July 13, 1979.

Dr. ARNOLD MILLER,
Office of Budget, Planning and Evaluation, Office of the Secretary, Room 117-A Administration Building, U.S. Department of Agriculture, Washington, D.C.

DEAR DR. MILLER: This letter is in response to the notice in the Federal Register of June 29, 1979, relative to implementation of the Federal Revenue Act of 1978.

The State of Iowa has been providing cost-share assistance to landowners since 1973. We are interested in having these payments excluded from gross income for federal tax purposes.

Seven of our county soil conservation districts are providing similar cost-share assistance to landowners from county funding sources. Their programs follow the state program guidelines regarding fund disbursement and eligible practices. I enclose six copies of an excerpt from the Code of Iowa which relates to districts entering into agreements and providing financial assistance. Also enclosed are six copies of the Story and Polk County SCD contracts. The contracts, in essence, are rules, policies and practices followed. Five other county contracts are deleted from this mailing since they are nearly a duplicate of the Story County SCD contract.

Since soil conservation districts are subdivisions of the State of Iowa and the cost-share programs are the same, we are requesting that these payments also be excluded from gross income for federal tax purposes.

The purpose of the state and county cost-share programs is to accelerate the installation of permanent land treatment practices which protect the land from deterioration and provide off-site benefits. These programs allow more landowners to participate and apply soil conservation practices than would be accomplished with the Agricultural Stabilization and Conservation Service program. Landowners participating in the state and county programs are restricted to construction of permanent land treatment practices and must adhere to the technical standards of the Soil Conservation Service for design and installation.

I believe that the rules and procedures included adequately explain the Iowa programs. If you have any questions, please contact our office.

We will appreciate your assistance in securing these exemptions.

Sincerely,

LAWRENCE G. VANCE,
Director.

Enclosures.

PAPIO NATURAL RESOURCES DISTRICT,
Omaha, Nebr., July 16, 1979.

Dr. ARNOLD MILLER,
Office of Budget, Planning and Evaluation, Office of the Secretary, Administration Building, U.S. Department of Agriculture, Washington, D.C.

DEAR DR. MILLER: I have just been advised of your request for comments and suggestions on implementation of the Revenue Act of 1978 relating to the exclusion of certain payments from gross income as described in Page 37953 of the Federal Register, Volume 44, No. 127, Friday, June 29, 1979.

The Papio Natural Resources District provides financial assistance to landowners through the District's Conservation Assistance Program and Wildlife Habitat Program. These programs encourage the application of soil and water conservation practices and retention of wildlife habitat in the District. The enclosed brochures describe the current policies and procedures under which payments are made and a description of the practices or measures for which payments are made. The Papio Natural Resources District is a local governmental sub-division in the State of Nebraska and these programs are carried out pursuant to the enabling legislation which established NRDs.

I would request that you consider payments that are received through the NRD's programs be included in those which are excluded from gross income for Federal tax purposes similar to the programs of the Agricultural Stabilization Service, U.S.D.A.

If you desire additional information on the District's programs, please advise.

Very truly yours,

JERRY R. WEHRSPANN, P.E.,
General Manager.

Enclosures.

IOWA DEPARTMENT OF SOIL CONSERVATION
Des Moines, Iowa, September 14, 1979.

DR. ARNOLD MILLER,
Office of Budget, Planning and Evaluation, Office of the Secretary, Administration Building, U.S. Department of Agriculture, Washington, D.C.

DEAR DR. MILLER: In my letter to you dated July 13, 1979, I requested that the state cost-share program and the county cost-share programs be included in the proposed rules as outlined in the Federal Register, Volume 44, No. 164, dated August 22, 1979. Upon receipt of the Federal Register, I found that, while you did include the state cost-share program, the cost-share programs funded by county monies were not included.

I am hereby requesting that, in section 14.6(a) on page 49273 and in the explanation given under paragraph (4) on page 49272, the definition of state programs should include programs funded by counties or other substate entities. If it does not, this will discourage any county input whatsoever into conservation cost-sharing programs and will turn off those that are already started.

Sincerely,

LAWRENCE G. VANCE,
Director.

Senator BYRD. Thank you, sir.

Mr. Ferguson, do you have a comment on that?

Mr. FERGUSON. Section 126 is a provision that excludes payments from income. On the basis of the information now available, I am not sure whether Mr. Boothly is talking about expanding the program very slightly in terms of the number of individuals covered, or whether this proposal would result in a severalfold expansion. The exclusion is now limited to a few programs. Before it is expanded substantially beyond those programs—expanded through the local levels—that the issue should be subjected to substantive policy debate and not to a technical amendment.

Senator BYRD. Thank you.

Mr. Skinner.

STATEMENT OF ROBERT SKINNER, INCOMING PRESIDENT, WESTERN ASSOCIATION OF EQUIPMENT LESSORS

Mr. SKINNER. Good afternoon, Mr. Chairman.

I am Robert Skinner. I am president of Renniks Leasing Co., a small independent leasing firm which I started just 1 year ago in Santa Ana, Calif. Prior to this I was a cofounder and president of a large independent leasing company for 16 years. I am here this afternoon as the incoming president of the Western Association of Equipment Lessors. With me today is William Hetts, tax partner, Deloitte, Haskin & Sales of San Francisco who are one of our members and advisers.

WEAL, as we abbreviate it, is a relatively new organization with 190 member firms located in the 11 Western States. The primary purpose of our organization has been to exchange ideas and provide an educational vehicle for the expanding leasing industry to try to keep up with the rapid changes and growth in our business. Of the 190 firms who comprise our membership, over 150 are what we would consider small independent leasing businesses or brokers. Among our membership we also have 13 bank leasing companies.

The members of our organization are very concerned about one section of the Technical Corrections Act and how it will affect the independent leasing business firm as well as the effect it may have on our ability to serve the business community. WEAL is still a young organization and quite honestly this is our first venture into

the legislative arena. We are concerned, too, about what to do and how to even proceed to express this concern. It was only 2 weeks ago that we learned about this pending legislation and the fact that it might contain provisions which could have some dramatic effects on our members.

Our specific areas of concern have to do with section 5, technical amendments relating to tax shelter provisions and subsections A through E.

As we understand, the "at risk" provisions of section 465 of the Internal Revenue Code were enacted in 1976 to prevent alleged abuses by so-called tax shelter transactions. As originally enacted, the provisions of section 465 applied only to individuals, trusts, subchapter S corporations, personal holding companies, and noncorporate partners of partnerships.

This proposed new section would waive the controlled group rule and allow an alternative test for determining, on a separate corporation basis, whether such separate corporation member of a controlled group is engaged in substantial leasing activity. As proposed, in order to avail itself of the separate corporation test, the gross receipts of such corporation from leasing activities must be 80 percent of the gross receipts of such corporation. In addition, proposed section 465(c)(5)(B) provides that three additional tests must be met by such corporation for the taxable year and each of the two immediately preceding taxable years of such corporation.

These three tests are (1) the group, for each of such 3 years, must have at least three full-time employees substantially all of whose services were directly related to the equipment leasing activity; (2) during each of such 3 years, the leasing members of the group must have entered into at least five separate equipment leasing transactions and (3) during each of such 3 years, the leasing members of the group must have had, in the aggregate, at least $1 million in gross receipts from equipment leasing.

By requiring equipment leasing corporations to meet these tests in not only the taxable year but also for the immediately preceding taxable years, the proposed amendments would preclude a controlled group of corporations from being excluded from the "at risk" provisions with respect to newly formed equipment leasing members of the group for a minimum of 3 years.

The way we read the statute as proposed, before you get to a separate company test there must be a control group of leasing corporations. This we understand to be two or more. We do not believe this is in the interest of Congress. However, the most troublesome requirement in the proposed legislation is the requirement that the aggregate gross receipts from equipment leasing in the taxable year, and in whatever applicable preceding period, must be at least $1 million.

The elimination of an absolute $1 million requirement would accomplish two objectives: (1) It would not penalize those controlled groups of corporations which have a leasing member in a startup position and (2) would stimulate the economy by encouraging smaller businesses to purchase and lease new equipment.

We do not believe the elimination of the flat $1 million requirement will lead to abuses because our proposals still leave intact the "80 percent of gross receipts" test, the "three employee" test and

the "five separate lease transactions" test. Since substantial capital would have to be invested by a corporation in equipment to be leased to meet these tests, it would, we believe, preclude the creation of a corporation solely for the purpose of tax avoidance.

Depending on how the present wording is interpreted, it could have a significant adverse impact on many small leasing firms as well as that segment of the business community which these people serve. More than one-third of our membership has been in business less than 3 years, and a far greater percentage would not currently meet this $1 million gross receipts criteria.

The independent leasing segment is still an important part of the market and will continue to be as the total market accelerates and expands. As in every industry, we, the small lessor, offer a different degree of service and flexibility as well as personal rapport. We don't want an advantage, we just want to be able to compete on an equal basis. The small businessman supports equality in taxes for large or small.

In summary, the members of our organization feel that the amendments of the "at risk" provision need clarification and modification. As presently drafted the law could dramatically impact the small and new independent lessors and would inhibit the growth of independent lessors. It would also limit the business community in being served by the independent lessors. Our proposal relating to the 3-year provision would eliminate or substantially reduce the $1 million requirement.

Thank you, sir.

Senator BYRD. Thank you, Mr. Skinner.

As I understand it you oppose a part of the technical corrections bill. You oppose a section in the technical corrections bill as passed by the House of Representatives.

Mr. SKINNER. Yes, section 465(c)(5).

Senator BYRD. From what you say, that so-called technical correction is in your view at least a substantive change.

Mr. SKINNER. Correct.

Senator BYRD. Would the Treasury want to comment on that?

Mr. FERGUSON. Mr. Chairman, the intent of the House-passed-technical corrections bill is to liberalize an exception to the at-risk provisions. The Revenue Act of 1978 created an exception from the at-risk rules for active leasing companies. They were defined in the 1978 act as companies with 50 percent of the gross receipts from leasing activities.

The 50-percent rule applied to an entire controlled group necessarily; otherwise, a corporation could simply spin off a subsidiary, combine all the leasing activities in the sub, and avoid the at-risk limitations. However, it was pointed out to various staff members that there were certain leasing groups that could not meet the 50-percent rule but nonetheless carried on substantial leasing activities; that observation led to the three-prong test mentioned in Mr. Skinner's testimony. The three-prong test in the House bill is intended as a liberalization.

I think, at this point it would be worthwhile for the staff members on the Hill and the staff members at Treasury to discuss the particular concerns expressed today. If there is a better way of stating what was intended on the House side, if there is some

unintended impact of the House provision, we would certainly like to know about it. We would be anxious to discuss this matter with the witness.

Senator BYRD. Well, does this not go beyond the scope of technical correction; that is, what the House did in regard to this item?

Mr. FERGUSON. Well, if the House provision does go beyond the scope of a technical correction, it goes beyond it in the taxpayer's favor. I am not sure what particular problem arises in the case of this witness, maybe it is just ambiguity in the language. If so, we can clarify the ambiguity through a drafting change. But the clear intent of the House was to liberalize the 1978 rules for applying the exception.

Senator BYRD. Mr. Skinner, why don't you get together with Treasury and the committee staff to see what can be done.

Mr. SKINNER. We would be very happy to.

[The prepared statement of Mr. Skinner follows:]

TESTIMONY OF ROBERT SKINNER, RENNIKS LEASING, SANTA ANA, CALIF., INCOMING PRESIDENT, WESTERN ASSOCIATION OF EQUIPMENT LESSORS

SUMMARY OF PRINCIPAL POINTS

Pertaining to Section 5, Technical Amendments relating to Tax Shelter Provisions.

1. The wording appears, at least ambiguous.
2. Depending on interpretation it could impact dramatically on the small and new independent lessor.
3. In turn, that impact would inhibit the growth of independent lessors.
4. It would also limit the business community in being served by the independent lessor.
5. WAEL proposes to offer amendments: a. Relating to three year provision, add "or for such part of such period immediately preceding such taxable year as may be applicable." b. Eliminate $1,000,000 requirement.
6. Without causing damage to small businessmen, amendments will maintain intent of section.

Good afternoon, my name is Robert Skinner. I am President of Renniks Leasing Company, a small independent leasing firm which I started just a year ago in Santa Ana, California. Prior to this, I was a co-founder and President of a large independent leasing company for 16 years. I am here this afternoon as the incoming President of the Western Association of Equipment Lessors. With me today is William Hetts, tax partner, Deloitte, Haskin & Sells of San Francisco who are one of our members and advisors.

WAEL as we abbreviate it, is a relatively new organization with one hundred and ninety member firms located in the 11 Western States. The primary purpose of our organization has been to exchange ideas and provide an educational vehicle for the expanding leasing industry to try and keep up with the rapid changes and growth in our business. Of the one hundred and ninety firms who comprise our membership over one hundred and fifty are what we would consider small independent leasing businesses or brokers. Among our membership we also have thirteen bank leasing companies.

The members of our organization are very concerned about one section of the Technical Corrections Act, and how it will effect the independent leasing business firm as well as the effect it may have on our ability to serve the business community. WAEL is still a young organization and quite honestly this is our first venture into the legislative arena. We are concerned too about what to do how to even proceed to express this concern. It was only two weeks ago that we learned about this pending legislation and the fact that it might contain provisions which could have some dramatic effects on our members.

Our specific areas of concern have to do with Section 5, Technical Amendments relating to Tax Shelter provisions and Sub Section A through E.

As we understand, the "at risk" provisions of section 465, of the Internal Revenue Code, were enacted in 1976 to prevent alleged abuses by so-called "tax shelter" transactions. As originally enacted, the provisions of section 465 applied only to

individuals, trusts, Subchapter S Corporations, personal holding companies and noncorporate partners of partnerships.

The Revenue Act of 1978 extended the "at risk" provisions of section 465 to "closely-held" corporations. Such "closely-held" corporations were defined by reference to section 542(a)(2) of the Code to include those corporations where, at any time during the last half of the taxable year, more than 50 percent in value of the corporation's outstanding stock is owned, directly or indirectly, by for not more than five individuals.

However, the Revenue Act of 1978 excluded from the "at risk" rules those "closely-held" corporations which are actively engaged in leasing tangible personal property (or, as it is referred to in the Code, "Section 1245 Property"). In determining whether a "closely-held" corporation is actively engaged in leasing equipment which is section 1245 property, section 465(c)(3)(D)(ii)(II) now provides that "a closely-held corporation . . . shall not be considered to be actively engaged in leasing such equipment unless 50 percent or more of the gross receipts of the corporation for the taxable year are attributable . . . to leasing the selling such equipment."

Section 465(c)(3)(D)(ii)(II) now provides that "in case of a controlled group of corporations (within the meaning of section 1563(a), this paragraph shall be applied by treating the controlled group as a single corporation."

The effect of this latter provision was to apply the "at risk" limitations to a number of substantial leasing operations because the gross receipts of some members of a controlled group of corporations could be substantial in the absolute sense, but would not constitute 50 percent of the aggregate gross receipts of all members of the controlled group. The proposed Technical Corrections Bill of 1979 now proposes to solve this problem by deleting all of section 465(c)(3)(D)(ii) and substituting, a new section 465(c)(5).

This proposed new section would waive the controlled group rule and allow an alternative test for determining, on a separate corporation basis, whether such separate corporation member of a controlled group is engaged in substantial leasing activity. As proposed, in order to avail itself of the separate corporation test, the gross receipts of such corporation from leasing activities must be 80 percent of the gross receipts of such corporation. In addition, proposed section 465(c)(5)(B) provides that three additional tests must be met by such corporation for the taxable year and each of the two immediately preceding taxable years of such corporation. These three tests are (1) the group, for each of such three years, must have at least 3 full-time employees substantially all of whose services where directly related to the equipment leasing activity; (2) during each of such three years, the leasing members of the group must have entered into at least five separate equipment leasing transactions and (3) during each of such three years, the leasing members of the group must have had, in the aggregate, at least $1,000,000 in gross receipts from equipment leasing. By requiring equipment leasing corporations to meet these tests in not only the taxable year, but also for the two immediately preceding taxable years, the proposed amendments from being preclude a controlled group of corporations from being excluded from the "at risk" provisions with respect to newly formed equipment leasing members of the group for a minimum of three years. Speaking to this narrow provision only, such a result could be eliminated by addition of a parenthetical clause in proposed section 465(c)(5)(B) which would read somewhat as follow: "or for such part of such period immediately preceding such taxable year as may be applicable."

However, the most troublesome requirement in the proposed legislation is the requirement that the aggregate gross receipts from equipment leasing in the taxable year, and in whatever applicable preceding period, must be at least $1,000,000. This would preclude the exemption from the "at risk" rules for a corporation which is a member of a controlled group, the activities of which are solely equipment leasing, but are not of a sufficient magnitude to meet presently proposed high dollar requirement of a leasing volume of $1,000,000 in gross receipts. We would recommend that such absolute dollar limit be eliminated. The effect of this proposal would be to allow a corporation that is member of a controlled group the exemption from the "at risk" rules, provided that such corporation's gross receipts from leasing are 80 percent or more of the total gross receipts such corporation.

The elimination of an absolute $1,000,000 requirement would accomplish two objectives: (1) it would not penalize those controlled groups of corporations which have a leasing member in a "start-up" position and (2) would stimulate the economy by encouraging smaller businesses to purchase and lease new equipment.

We do not believe the elimination of the flat $1,000,000 requirement will lead to abuses because our proposals still leaves intact the "80 percent of gross receipts" test, the "three employee" test and the "five separate lease transactions" test. Since

substantial capital would have to be invested by a corporation in equipment to be leased to meet these tests, it would, we believe, preclude the creation of a corporation solely for the purpose of tax avoidance.

Many of our WAEL members could be at a disadvantage by the present wording of this act, either because they cannot meet the three year requirement or the one million dollars in gross leasing receipts.

Depending on how the present wording is interpreted, it could have a significant adverse impact on many small leasing firms as well as that segment of the business community which these people serve. More than one-third of our membership has been in business less than three years, and a far greater percentage would not currently meet this $1,000,000 gross receipts criteria.

It is anticipated that the leasing industry will continue to experience exciting and dramatic growth over the next five and ten years. As the ravages of inflation continues to impact the business community, leasing has and will continue to be a much better understood and much more used vehicle to finance the capital growth which most business and our entire economy must achieve.

Perhaps, 60% to 70% of today's leasing business is being done by what might be called the large leasing companies and banks. That's significant, however, the independent leasing segment, is still an important part of the market mix and will continue to be as the total market accelerates and expands.

The large banks and corporate lessors, may dominate the market, but they can never serve it all. There are, as in every industry a different degree of service and flexibility as well as personal rapport that the small businessman can offer, that our larger colleagues cannot.

We have our total net worth on the barrel head, right on the line everyday competing with these corporate giants. We don't want an advantage, we just want to be able to compete on an equal basis. The small businessman supports equality in taxes for large or small.

In summary, the members of our organization feel there is at very least some ambiguity in the wording of Section 5. Our proposals to amend that wording and eliminate the $1,000,000 gross leasing receipts requirement would clear up the ambiguity, without, we believe damaging the intent of the proposed section—and it will accomplish that purpose without impairing the ability of the small businessman to function or impair his ability to serve the business community.

Senator BYRD. The next panel consists of Ernest S. Christian, Jr.; Albert G. Doumar, and Patrick A. Naughton, Committee of Banking Institutions on Taxation; and Matthew Newman, international pension consultants.

Welcome, gentlemen. Proceed as you wish.

STATEMENT OF ERNEST S. CHRISTIAN, JR.

Mr. CHRISTIAN. Mr. Chairman, I would ask that my written statement be made part of the record.

Senator BYRD. Without objection, so ordered.

Mr. CHRISTIAN. The subject of my testimony, Mr. Chairman, is section 701(u)(2)(C) of the 1978 act which deals with the question of the character to be given to gain realized from the sale of stock outside the United States, most particularly the sale of stock by one corporation of stock in another corporation.

Senator BYRD. Now is this a technical correction?

Mr. CHRISTIAN. Yes, sir, I believe it is. In fact, it is a technical correction to the technical correction portion of the 1978 act. As you know, title VII of the 1978 act was in fact the Technical Corrections Act of 1978 dealing with the 1976 act.

Senator BYRD. Well, does your proposal deal with 1976 or 1978?

Mr. CHRISTIAN. The proposal here is to make a correction to the technical correction made in 1978 to the 1976 act.

The background, Mr. Chairman, is that in the 1976 act, section 904(b)(3) was amended to provide substantial restrictions on the extent to which income from the sale by one corporation of stock in

another corporation outside the United States would be treated as foreign source income.

Senator BYRD. It seems to me you are getting into a substantive matter here.

Mr. CHRISTIAN. I believe, Mr. Chairman, virtually the identical provision was treated as a technical correction in 1978 and that is the provision that we are now asking be changed or modified.

The 1978 act provided an exception to the general rule and clarified that the 1976 act had gone too far. The 1978 act provided that the income from the sale of stock would be treated as foreign source income if it resulted from the liquidation of a foreign corporation which had for the previous 3 years derived more than 50 percent of its income from operations outside the United States.

The 1978 act failed to address the virtually identical transaction where the gain results not from the liquidation of the foreign corporation but from the sale of more than 80 percent of the stock of the foreign corporation. In substance, the amendment that I am suggesting to the committee would clarify the change made by the 1978 act and provide that a sale of stock would be treated the same as a liquidation.

Thank you very much, Mr. Chairman.

Senator BYRD. Thank you.

Does Treasury have a comment on that?

Mr. FERGUSON. Mr. Chairman, I have a general comment. The Technical Corrections Act, relating to the 1976 Reform Act, was included in the Revenue Act of 1978; it was tacked onto the substantive portion of the 1978 act. As a general matter, there is a substantial problem with permitting 1976 act changes that happen to be addressed in the technical corrections portion of the 1978 act to be in turn amended this year. If this procedure is permitted, we will have a snowball and will be amending a statute passed several years ago.

In this case, I have not had time to focus on the amendment. I offer this general comment as a reservation and also offer the comment that, as you suggested, we hope to keep the bill technical in nature. We would like to examine this particular amendment to see if it falls within those constraints in our view.

Senator BYRD. Thank you.

[The prepared statement of Mr. Christian follows:]

STATEMENT OF ERNEST S. CHRISTIAN, JR.

SUMMARY OF STATEMENT

1. As a technical correction to the 1976 Act, the 1978 Act provided that gain from the liquidation of a foreign corporation would, despite the more restrictive rule in section 904(b)(3)(C), be treated as foreign source income if the corporation which was liquidated derived more than 50 percent of its income from sources outside the U.S. for the immediately preceding three years.

2. The 1978 Act failed to make the same correction where the gain was derived from sale of substantially all the stock of the same corporation.

3. The 1978 Act should be corrected to provide the same rule for disposition by sale of 80 percent of the stock of a foreign corporation.

H.R. 2797 should be modified to include an additional technical correction related to the determination of foreign source income, where one corporation realizes gain from the disposition of stock in a second corporation.

Prior to the Tax Reform Act of 1976, it had been possible for a domestic corporation to increase the limitation on allowable foreign tax credits by selling at a

location outside the United States the stock of a second corporation. The capital gain on that sale was treated as foreign source income even though the corporation whose stock was disposed of derived all or substantially all its income from sources in the United States instead of from foreign sources.

In order to deal with this situation, the Tax Reform Act of 1976 amended Code section 904 to provide that the gain from disposition of the stock of the second corporation would be U.S. source income unless (i) the stock was sold in the foreign country where the second corporation had derived more than 50 percent of its income for the immediately preceding three years, or (ii) the stock was sold in a foreign country that imposed at least a 10-percent tax on the gain from disposition of the stock. Section 904(b)(3)(C).

There is no apparent reason why gain from the disposition of stock of a corporation which derives most of its income from foregin sources should be treated as U.S. source income. Indeed, so long as the underlying earnings and earnings potential which give the stock its value are foreign source, it is ony logical that gain on disposition of the stock should be treated as foreign source income also. This true whether or not the corporation whose stock is sold may, by happenstance, have derived more than 50 percent of its income in one particular foreign country. it is, for example, illogical to treat as foreign source income the gain from disposition of stock of a corporation which derived 51 percent of its income in foreign country A and 49 percent in the U.S.; and not to treat as foreign source income gain from the disposition of stock in a corporation which derived 100 percent of its income from sources outside the U.S.—one-third in each of foreign countries A, B, and C. Obviously, the gain should be foreign source in any cas where the corporation whose stock is sold derived more than 50 percent of its income from sources outside the U.S.

It is also obviously the case that there is no necessity to require that the country where the stock is sold impose at least a 10 percent tax on the gain. Capital gain taxes in foreign countries are usually less than in the U.S. and in some cases nonexistent. In those cases, a difference in the characterization of income based on the nominal distinction between a 10-percent and a 9-percent rate, or even a zero rate, is purely arbitrary. In other cases, however, the capital gain tax rate in the country where the corporation derives most of its income may be higher than the U.S. rate. There is no rational reason for requiring a U.S. corporation to pay the highest possible foreign tax rate on the sale, or to make the sale in a country which imposes a tax of at least 10 percent. In both cases, the effect is merely to increase tax payments by U.S. taxpayers to foreign countries and to increase the amount of available foreign tax credit.

These defects in the Tax Reform Act of 1976 were recognized and partially corrected by Title VII of the Revenue Act of 1978 which dealt with technical corrections to the Tax Reform Act of 1976. Section 701(u)(2)(C) of the 1978 Act added Code section 904(b)(3)(D) which corrected the 1976 Act insofar as concerns gain from the disposition of stock in a liquidation. Section 904(b)(3)(D) in effect provides that gain from the disposition of stock by means of liquidation of a foreign corporation will be treated as foreign source income if the liquidated corporation derived more than 50 percent of its income from foreign sources for the immediately preceding three years. This correction of the 1976 Act eliminated the requirement that the corporation have derived more than 50 percent of its income in any one particular foreign country and eliminated the requirement that at least a 10-percent tax have been paid in the foreign country where the liquidation occurred. As previously discussed, section 904(b)(3)(D) represents the correct rule for determining the source of gain from the disposition by one corporation of stock of a foreign corporation outside the United States. Because the amendment made by the 1978 Act was a technical correction of the 1976 Act, it was made effective as of the effective date of the provision in the 1976 Act which it corrected; i.e., taxable years beginning after December 31, 1975.

The 1978 Act failed, however, to correct the 1976 Act insofar as concerns gains from the dispostion of stock in a foreign corporation when that disposition is in the form of a sale of stock instead of a liquidation. There is no apparent distinction between a liquidation of a corporation and a sale of at least 80 percent of the stock of the corporation.[1] The same rule, the one provided by the technical correction in the 1978 Act, should apply in both situations.

Therefore, it is proposed that section 701(u)(2)(C) of the 1978 Act be amended to provide that a sale of at least 80 percent of all classes of stock of a corporation

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[1] It has been suggested that a liquidation cannot artificially be arranged to occur in a low tax country, but as the analysis herein shows, and as implicitly accepted by the 1978 Act, the rational rule for determining the source of gain upon disposition relates to the source of the income derived by the corporation whose stock is sold; not to the rate of foreign tax on the sale.

would be treated the same as a liqudation. The following provision would be inserted after subparagraph (C) of paragraph (1) of section 107(a) of H.R. 2797: "(D) Subparagraph (C) of paragraph (2) of Section 701(u) of the Revenue Act of 1978 is amended—

(i) by inserting "and gain from sale of stock of certain foreign subsidiaries" after "gain from liquidation of certain corporations"; and

(ii) by inserting "or the gain from the sale of at least 80 percent of all classes of stock of a foreign corporation" after "to which part II of subchapter C applies."

Because this suggested amendment is a technical correction to the technical correction made by the 1978 Act to the 1976 Act, it would have the same effective date—taxable years beginning after 1975.

I would also call the Committee's attention to one other aspect of H.R. 2797. While the amendment of section 904(b)(3)(D) which I have outlined is a technical amendment to the 1978 Act and, therefore, within the scope of this hearing, there are a large number of additional, smaller, noncontroversial amendments, not related to the 1978 Act, which also need to be enacted this year. I would strongly urge that when the Committee gets to mark-up on H.R. 2797, its scope should be expanded to include other noncontroversial, Treasury supported, amendments in order that these other much needed matters may be acted on this year also. Among these are an amendment to section 871(f) dealing with the 30-percent withholding tax on low income nonresident aliens who receive pensions from U.S. situs pensions and profit-sharing plans. I have submitted a separate written statement on that amendment for inclusion in the record of these hearings.

Senator BYRD. Mr. Doumar.

STATEMENT OF ALBERT G. DOUMAR, CHAIRMAN, FIDUCIARY COMMITTEE OF THE COMMITTEE ON BANKING INSTITUTIONS ON TAXATION, ACCOMPANIED BY PATRICK A. NAUGHTON, MEMBER

Mr. DOUMAR. Mr. Chairman, my name is Albert G. Doumar and I appear before the committee in my capacity as chairman of the Fiduciary Committee of the Committee of Banking Institutions on Taxation, an organization of tax officers of the major metropolitan New York banks and with representation from the major banks throughout the United States. Mr. Naughton, a member of my committee, has joined me today.

I am a second vice president in the tax services group of the Chase Manhattan Bank, N.A. I thank the committee for the opportunity of testifying today.

These comments and recommendations relate to "adjusted itemized deductions" as they relate to estate and trust accounts, that is, IRC section 57(b)(2).

Under current law (section 57(b)(2)(A)(i)), deductions allowable in arriving at adjusted gross income would be deducted twice in order to arrive at a modified adjusted gross income for the purposes of calculating adjusted itemized deductions.

Section 104(a)(4)(F) of the technical corrections bill of 1979—H.R. 2797—would correct this defect in the current law. However, we feel that there are other technical defects in the current law which also should be taken into consideration in the technical corrections bill of 1979.

First, under current law, the deduction for personal exemption provided by section 642(b) is to be subtracted from adjusted gross income.

This is inconsistent with the treatment accorded an individual taxpayer. Section 57(b)(1) in defining adjusted itemized deductions states, in part, that it is "* * * the amount by which the sum of

the itemized deductions (as defined in section 63(f)) other than * * *." Since section 63(f) excludes the deductions for personal exemptions provided by section 151 from the term "itemized deductions," the personal exemption under section 642(b) should not be subtracted from adjusted gross income.

The second point, we feel that the distribution deduction provided for by section 651(a) and 661(a) should not be deducted from adjusted gross income.

The distribution deduction is not a deduction in the true sense of the word. Instead, it represents the amount of income which is taxable to a beneficiary and as such serves the purpose of avoiding double taxation of the same income. To subtract the distribution deduction from adjusted gross income would work an inequity in regard to trusts whose income is currently distributable or distributed as opposed to those which accumulate income. Because of the now required subtraction of the distribution deduction from adjusted gross income, trusts whose income is currently distributable would almost automatically have adjusted itemized deductions even though on an overall basis its itemized deductions, other than the distribution deduction, are only a small percentage of its gross income. The below examples should illustrate this point.

Example 1: Trust A, whose income is currently distributable, and trust B, whose income is accumulated, each generate $10,000 of taxable income and incur an interest expense charged to the corpus of the trust of $3,000.

The beneficiary of trust A, in addition to taxable income of $7,000, would also have to report adjusted itemized deductions of $1,380 while trust B would only have taxable income of $7,000, as calculated below:

Calculation of DNI:	
Gross taxable income	$10,000
Less: Interest expenses	3,000
Total—(Same for trust A and B)	7,000
Calculation of adjusted itemized deductions—Trust A:	
Gross taxable income	10,000
Less:	
Personal exemption	300
Distribution deduction	7,000
Total—Adjusted AGI	2,700

Accordingly, we end up with $1,380 that would be an adjusted itemized deduction that would be reportable by the beneficiary when in fact only 30 percent of gross income represents deductions.

The second example is basically the same with $100,000 of income and $3,000 of interest deductions. We see in this case that our deductions represent only 3 percent of gross income, however, we still have adjusted itemized deductions being taxable to the beneficiary.

The third point involves section 57(b)(a)(A)(vi) and the amount here should not be subtracted from AGI since in effect this amount is equivalent to the distribution deduction, that is it is taxable income included in the section 642(c) deduction which is taxable to the income beneficiary.

Should I continue, sir?

Senator BYRD. Your total statement will be put in the record.

Senator BYRD. Does Treasury have a comment?

Mr. FERGUSON. Mr. Chairman, on page 37 of the attachment to my statement there is a proposal that the allocation of tax preference items between a trust and the beneficiaries or an estate and the beneficiaries be apportioned in accordance with Treasury regulations. We recognize that there are some problems in current law, and we think they should be dealt with through regulations if regulations can handle the problem. If they cannot, perhaps we should consider an additional technical amendment.

Senator BYRD. Does your page 37 take care of Mr. Doumar's problem?

Mr. FERGUSON. I believe it would take care of at least part of it. What the amendment would do is override the current provision and provide that the allocation of tax preference items between a trust and beneficiaries or an estate and beneficiaries would be determined in accordance with Treasury regulations rather than in accordance with income as the statute now provides.

I think that amendment would take care of a portion of their problems. Again, this proposal could be discussed on the staff level to see for sure what the witnesses have in mind.

Senator BYRD. I think that is a good idea.

Mr. Doumar, why don't you consult with Treasury and staff and see what can be worked out to try to solve your problem.

Mr. DOUMAR. Thank you.

[The prepared statement of Mr. Doumar follows:]

PREPARED STATEMENT OF ALBERT G. DOUMAR, COMMITTEE OF BANKING INSTITUTIONS ON TAXATION

My name is Albert G. Doumar and I appear before the Committee in my capacity as Chairman of the Fiduciary Committee of the Committee of Banking Institutions on Taxation an organization of tax officers of the major metropolitan New York banks and with representation from the major banks throughout the United States. I am a Second Vice President in the Tax Services group of The Chase Manhattan Bank, N.A. I thank the Committee for the opportunity of testifying today.

These comments and recommendations relate to "Adjusted Itemized Deductions," as they relate to estate and trust accounts, i.e., IRC Section 57(b)(2).

Under current law (Section 57(b)(2)(A)(i)), deductions allowable in arriving at adjusted gross income would be deducted twice in order to arrive at a modified adjusted gross income for the purposes of calculating "adjusted itemized deductions."

Section 104(a)(4)(F) of the Technical Corrections Bill of 1979 (H.R. 2797) would correct this defect in the current law. However, we feel that there are other technical defects in the current law which also should be taken into consideration in the Technical Corrections Bill of 1979.

1. Under current law, the deduction for personal exemption provided by Section 642(b) is to be subtracted from adjusted gross income.

This is inconsistent with the treatment accorded an individual taxpayer. Section 57(b)(1) in defining adjusted itemized deductions states, in part, that it is ". . . the amount by which the sum of the itemized deductions (*as defined in Section 63(f)*) other than. . . ." Since Section 63(f) excludes the deductions for personal exemptions provided by Section 151 from the term "itemized deductions," the personal exemption under Section 642(b) should not be subtracted from adjusted gross income.

2. We feel that the distribution deduction provided for by Section 651(a) and 661(a) should not be deducted from adjusted gross income.

The distribution deduction is not a deduction in the true sense of the word. Instead, it represents the amount of income which is taxable to a beneficiary and as such, serves the purpose of avoiding double taxation of the same income. To subtract the distribution deduction from adjusted gross income would work an inequity in regard to trusts whose income is currently distributable or distributed as opposed

to those which accumulate income. Because of the now required substraction of the distribution deduction from adjusted gross income, trusts whose income is currently distributable would almost automatically have "adjusted itemized deductions" even though on an overall basis its itemized deductions, other than the distribution deduction, are only a small percentage of its gross income. The below examples should illustrate this point.

Example 1: Trust A, whose income is currently distributable, and Trust B, whose income is accumulated, each generate $10,000 of taxable income and incur an interest expense charged to the corpus of the trust of $3,000.

The beneficiary of Trust A, in addition to taxable income of $7,000, would also have to report adjusted itemized deductions of $1,380 while Trust B would only have taxable income of $7,000, as calculated below.

Calculation of DNI:	
Gross taxable income	$10,000
Less: Interest expenses	3,000
Total—(Same for trust A and B)	7,000
Calculation of adjusted itemized deductions—Trust A:	
Gross taxable income	10,000
Less:	
Personal exemption	300
Distribution deduction	7,000
Total—adjusted AGI	2,700
Itemized deduction	3,000
Less: 60 percent of adjusted AGI	1,620
Total adjusted itemized deduction	1,380
Trust B:	
Gross taxable income	10,000
Less: Personal exemption	100
Total adjusted AGI	9,900
Itemized deduction	3,000
Less: 60 percent of adjusted AGI	5,940
Total adjusted itemized deduction	0

NOTE.—On an overall basis, the $3,000 interest deduction represents only 30 percent of Trust A's gross income but because of the subtraction of the distribution deduction from AGI the beneficiary is inequitably subjected to report an item of tax preference that does not apply to our accumulation trust, Trust B, nor would it apply if the above were reportable in his own return.

Example 2: Trust A, whose income is currently distributable, and Trust B, whose income is accumulated, each generate $100,000 of taxable income and incur an interest expense charged to the corpus of the trust of $3,000.

The beneficiary of Trust A, in addition to taxable income of $97,000, would also have to report adjusted itemized deductions of $1,380 while Trust B would only have taxable income of $97,000 as calculated below.

Calculation of DNI:	
Gross Taxable Income	$100,000
Less: Interest Expenses	3,000
Total—Same for trust A and B	97,000
Calculation of Adjusted Itemized Deductions—Trust A:	
Gross taxable income	100,000

Less:	
Personal exemption	300
Distribution deduction	97,000
Total adjusted AGI	2,700
Itemized deduction	3,000
Less: 60 percent of adjusted AGI	1,620
Total adjusted itemized deduction	1,380
Trust B:	
Gross taxable income	100,000
Less: Personal exemption	100
Total adjusted AGI	99,900
Itemized deduction	3,000
Less: 60 percent of adjusted AGI	59,940
Total adjusted itemized deduction:	0

NOTE.—In the above example our itemized deductions are only 3 percent of the gross income and once again because of the subtraction of the distribution deduction the beneficiary of Trust A has an item of tax preference. Further, please note that the beneficiary of Trust A in Example 1, who received $7,000 of taxable income as opposed to $97,000 in Example 2, has the same amount of adjusted itemized deduction ($1,380) to report. Once again, this distortion is caused by the current law requiring that the distribution deduction be subtracted from AGI.

3. The amount provided for in Section 57(b)(2)(A)(vi) should not be subtracted from AGI since in effect this amount is equivalent to the distribution deduction, i.e., it is taxable income included in the Section 642(c) deduction which is taxable to the income beneficiary.

In accordance with Section 57(b)(2)(C) certain charitable contributions deductible under Section 642(c) are to be treated as deductions allowable in arriving at AGI. However, the charitable deduction should be reduced by the amount provided in Section 57(b)(2)(A)(vi).

If the current law is amended so that the distribution deduction would no longer be subtracted from AGI, the amount provided for in Section 57(b)(2)(A)(vi) should, as stated above, be used to reduce the charitable deduction that is applied against AGI. However, if the distribution deduction remains as an offset against AGI, Section 57(b)(2)(A)(vi) should be repealed since under current law the amount provided for would be deducted twice.

4. We suggest that in the final year of an estate or trust account wherein "excess deductions" as provided under Section 642(h) are involved, no calculation of adjusted itemized deductions on the entity level should be required. This we feel would avoid an inequity wherein the recipient's adjusted itemized deductions could be greater than the amount of the itemized deductions, as illustrated below.

Trust or estate—Final year:	
Gross taxable income	$1,000
Less:	
Interest deduction	11,000
Excess deductions	−10,000
Calculation of adjusted itemized deductions:	
Itemized deductions	11,000
Less: 60 percent of AGI of $1,000	600
Total	10,400

Here, assume that the recipient remainderman has $10,000 of taxable income and no itemized deductions other than the "excess deductions" of $10,000.

Calculation of Adjusted Itemized Deductions on Remainderman's Level:

Itemized Deductions, i.e., the "Excess Deduction"	$10,000
Less: 60 percent of AGI of $10,000	6,000
Total	4,000

NOTE.—As a result of calculating adjusted itemized deductions on the entity level when excess

deductions are involved, the recipient remainderman has adjusted itemized deductions of $14,400 whereas the itemized deductions only total $11,000.

Senator BYRD. Mr. Newman.

STATEMENT OF MATTHEW E. NEWMAN, TECHNICAL DIRECTOR, INSTITUTIONAL PENSION CONSULTANTS

Mr. NEWMAN. Senator Byrd, my name is Matthew E. Newman. I am appearing on behalf of IPCO, Inc. a New York based consulting company of which I am the technical director, and the National Retirement Plans Training Conference, Inc.—NRPTC—a nationwide nonprofit trade association consisting of commercial banks, savings and loan institutions, mutual savings banks, and credit unions.

Also present today is John Allen, director of Washington operations for the two institutions who has an office in Alexandria, Va.

In these two capacities I am here representing over 1,000 institutions ranging in size from $2.5 million in assets to over $30 billion in assets.

I would like to point out that any statements we make today are not statements of any individual financial institution which is a member of the NRPTC or any client of IPCO, Inc., but rather they are based solely upon our experience providing services to financial institutions throughout the country.

The written testimony has been provided to the committee and I request that it be entered into the record. The point of our written comments and today's oral testimony is the simplified employee pension plan, SEP.

Financial institutions throughout the country are going through a period of rapid disintermediation of funds, a crisis of confidence and general problems for which legislative solutions are being sought. Just last week the Senate passed the Depository Institutions Deregulation Act—H.R. 4986—which among other things would grant new trust powers to federally chartered savings and loan associations, permit greater consumer loans and generally make more funds available at higher interest rates for all depositors. While these are necessary steps for the economy as a means of encouraging capital formation and dealing with the inflationary spiral, they do not address the issue of pension fund deposits as a key to institutional stability, savings growth, et cetera.

During the first 6 months of 1979, New York State mutual savings banks had a net deposit outflow of $1.84 billion. In sharp contrast to this, during the same period, they had a net deposit inflow in pension funds of $329 million, primarily in IRA and Keogh funds. When the Revenue Act of 1978 was passed, the SEP was envisioned as a means of increasing private pension plan coverage, increasing savings and creating a simple pension plan for employers to adopt. Unfortunately, this has not occurred even though the IRS has just issued new model forms in this area.

The Technical Corrections Act addresses many of the SEP problems which make it unworkable now. Such issues as social security taxes, contributions for persons over the age of 70½, required coverage of certain individuals, et cetera, are dealt with. Unfortunately, additional key areas must be addressed now if these ac-

counts are to result in significant inflow of funds and coverage of employees.

Approximately one-half hour ago Mr. Ferguson of the Department of Treasury introduced a 45 page document which has 3 SEP changes and at least 15 changes dealing with employees stock option plans and other items. I believe this buttresses our view that there are additional changes that must be made. While I cannot comment on those changes now, I feel that a 2-week period as a minimum for comments should be approved by the committee.

As pointed out in our written statement, the major areas which must be addressed are the problem of eligibility and the possible excess contribution. In my brief time, I would like to discuss the eligibility issue only. Under the rules set forth in the Revenue Act of 1978 and the IRS model form 5305-SEP, if one eligible individual employee does not establish the simplified employee plan, it will fail for all other eligible employees. The resulting administrative chaos for the employer as well as the serious tax implications for all other employees has resulted in the failure of most employers to follow through and establish these plans as they initially intended to do.

The solution is to permit the individual employee to elect to receive the employer's contribution as either cash, in the form of wages or as deferred compensation in the form of a contribution into the simplified employee plan. While there may be a temporary desire to obtain cash today by the employee in terms of dealing with inflation, it is our belief that over the long run almost all employees will choose to participate in this type of retirement system. As we point out, this is not a new concept but is consistent with other areas of the Internal Revenue Code.

Without this type of approach to the simplified employee plan, congressional intent as evidenced by Revenue Act 1978 will have been thwarted. We urge that the Senate amend the Technical Corrections Act so that these plans can be established, so that additional retirement savings are available to employees and so that more individuals are covered by plans who otherwise would not be eligible for nor participate in any other tax deferred qualified plan.

Thank you very much.

[The prepared statement of Mr. Newman follows. Oral testimony continues on p. 248.]

INSTITUTIONAL PENSION CONSULTANTS, INC.,
New York, N.Y., November 27, 1979.

Mr. MICHAEL STERN,
Staff Director, Senate Finance Subcommittee on Taxation and Debt Management, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: Pursuant to Senator Byrd's statement on the 7th, we submit our written comments to the thirty-seven (37) additional items presented by the Department of the Treasury to the Subcommittee at the hearing referred to above. We enclose a copy of those comments which have been made directly to the Department of the Treasury, the enclosures, and our letter to Senator Byrd for your review and possible consideration.

Without being negative, our prime concern is that any amendments to TCA 1979 may delay passage of the Act. We strongly urge immediate passage of these sections, so that the SEP-IRA will be a viable alternative and addition to the employee benefit plan area in fiscal 1979.

If we can be of any further assistance to you and the staff, we would welcome the opportunity to be involved. At the same time, if any additional public hearings are to be held, we would request the opportunity to appear and make oral comments.

Thank you very much.
Very truly yours,

MATTHEW E. NEWMAN,
Technical Director.

NOVEMBER 27, 1979.

Mr. WILLIAM LEIBER,
Joint Tax Committee,
Longworth House Office Building, Washington, D.C.

DEAR BILL: Pursuant to our telephone conversation and discussions, we enclose copies of our letter to Brad Ferguson, the articles referred to therein and our written comments which had been submitted to the Subcommittee on November 7, 1979.

As you know, we are concerned about the apparent 180° difference in opinion between the Joint Committee and Treasury, as to required coverage under the SEP-IRA. While the Joint Committee Report on the Revenue Act of 1978 raises the possibility that a SEP-IRA could have a "date of employment" rule with respect to eligibility in the same manner as a qualified plan under § 401 of the Code, this concept does not appear in any of the hearings, reports, etc.

More significantly, Treasury has indicated that their view is that this is not permitted. In addition to oral discussions with Mike Melton and Brad Ferguson on this point, the IRS Model Form 5305-SEP does not permit this option.

Resolution of the eligibility and participation issues, plus the FICA tax consideration, will lead to rapid expansion and use of the SEP in fiscal 1979, the original Congressional intent.

While we believe our proposed election procedure is a simple, effective means of dealing with one reluctant employee in a nondiscriminatory manner, we can appreciate legislative concern as to how this could be done, while keeping SEP-IRA "simple". The key is that something must be done to clarify these issues.

If we can be of any assistance in resolving the apparent conflict in this area by meeting with you and representatives of the Department of the Treasury, we would be more than willing to do so. At the same time, we would welcome the opportunity to meet and discuss our alternative proposal with you and other members of the Joint Committee's staff.

Thank you very much.
Very truly yours,

MATTHEW E. NEWMAN,
Technical Director.

NOVEMBER 27, 1979.

Mr. MICHAEL W. MELTON, Esq.,
Office of Tax Legislative Counsel,
Department of the Treasury, Washington, D.C.

DEAR MIKE: Pursuant to our telephone conversation and discussions, I am enclosing a copy of our letter to Brad Ferguson, Bill Leiber, and the various articles referred to therein.

As we discussed, something must be done if employers and employees are to benefit from the SEP-IRA. While the intent of Congress was that this type of retirement system would primarily be adopted by small employers with less than ten (10) employees, our experience has been that the SEP could be an attractive alternative for the medium-sized employer.

Once the FICA tax, eligibility and participation issues are resolved, we see the SEP as a key element in the employee benefit arena. What is needed now is some element of certainty so that financial institutions can effectively offer this product and employers can adopt it.

We would welcome the opportunity to meet with you and/or other representatives of the Department to discuss the points that we have previously raised. Since we still see some serious problems with operating a SEP-IRA as an employer-sponsored IRA under § 408(c), we would like to discuss this in greater detail with you in the future.

Thank you very much.
Very truly yours,

MATTHEW E. NEWMAN,
Technical Director.

NOVEMBER 27, 1979.

Senator HARRY F. BYRD, Jr.,
Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: On Wednesday, November 7, 1979, I had the privilege of testifying before you and the other members of the Subcommittee with respect to needed changes and additions to the Technical Corrections Act of 1979. During my testimony and in our written comments, we urged the immediate passage of those sections of TCA 1979 which affect the Simplified Employee Pension Plan (SEP).

At the hearing, the Department of the Treasury introduced thirty-seven (37) changes and/or additions to TCA for consideration by the Subcommittee. You indicated that prior to any action by the Subcommittee, there would be a comment period on these proposals. Since then, we have discussed these proposals with both the Joint Committee, through Mr. Leiber, and the Department of the Treasury, through Messrs. Ferguson and Melton. Our main concern has been not the specific changes proposed but the real possibility that these proposals might delay the passage of TCA until 1980.

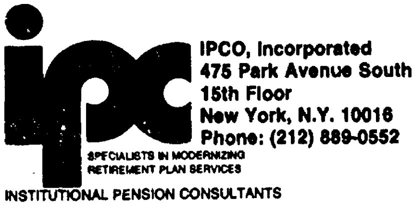
While we believe the technical change we proposed dealing with eligibility and participation should and could be easily enacted, it is more imperative that the other changes in TCA be enacted now, if the SEP-IRA is to be a viable alternative and option for fiscal 1979. Without quick affirmative action with respect to Social Security Taxes, exclusion of certain union employees, participation after age 70½, etc., we do not anticipate the adoption of the SEP for 1979.

We enclose copies of our letter to Mr. Ferguson and the various enclosures that we have submitted to the Department of the Treasury. The legislative intent, which was the basis of the SEP, was to create a simple pension plan to benefit both employers and employees starting in 1979. If TCA is quickly passed, this will occur; otherwise, it will not.

If we can be of any further assistance to the Committee, we would welcome the opportunity to offer our input into the legislative process.

Thank you very much.
Sincerely,

MATTHEW E. NEWMAN,
Technical Director.



November 27, 1979

Bradford L. Ferguson,
Associate Tax Legislative Counsel,
Department of The Treasury
15th and Pennsylvania Avenue, N.W.
Washington, DC 20220

RE: TCA '79 -
Proposed Dept. of Treasury
Changes and/or Additions

Dear Mr. Ferguson:

When we testified on Wednesday November 7, 1979, before the Subcommittee, we did not have the opportunity to comment in depth upon the numerous additions and modifications to the TCA which you submitted that day. As we discussed with Mike Melton of your staff after the hearings, and with you on November 9th, the specific language to be added to the Code has not moved beyond the draft/design stage. Rather, the written summary reflects views of the Treasury and the Joint Subcommittee on Taxation which have not yet been fully formulated.

The following represent our views with respect to two of these changes which affect Simplified Employee Pension Plans (SEPs) created under the Revenue Act of 1978.

Integration of SEP with Social Security: As we have pointed out in several of our newsletter articles (submitted herewith), in establishing his funding formula for the SEP under §408(k) of the Code, an Employer may take his FICA contributions into account. While Social Security integration is a complex subject, with numerous guidelines to prevent discrimination, it is often the key in an Employer's decision to establish a qualified plan. Considering the increase in the level of covered FICA compensation for 1978 and the increased rate of contribution, many Employers believe that they are already providing a sufficient pension for their employees. Recognizing the problems of those small Employers, who might wish to establish a SEP, Congress specifically allowed the FICA offset in the SEP.

BEST AVAILABLE COPY

The Treasury has taken the position that an Employer may not maintain both a conventional plan under §401 and a SEP under §408, when both plans are integrated with Social Security. Their position is that the statute was not meant to permit the Employer to utilize the FICA contribution twice; once in the SEP and once again in the qualified plan. Since the SEP is not a qualified plan under §401, the aggregation rules for integration would not otherwise apply.

While we agree with the Treasury's view of Congressional intent, we are concerned that the views contained in your summary may cause additional problems if enacted into law. You stated that "...a SEP could be integrated with Social Security only in those situations where the Employer does not maintain any other tax-qualified plan which provides for integration..."

We believe that this absolute rule is too harsh and does not recognize the realities of the situation. There are many plans which are partially integrated. In such a case, if the SEP is barred, the employer may decide to take full advantage of the maximum integration formula, to the detriment of many employees.

At the same time, we are concerned that the Treasury may go so far as to endorse the position of the Model Form 5305-SEP which may only be used if: 1) the Employer does not now maintain any other qualified plan, or 2) has never had a defined benefit plan in the past. A position as restrictive as yours would effectively eliminate the SEP as a viable alternative to a corporate qualified plan. At the same time, we believe that this type of substantive change was not contemplated in the concept of a technical corrections act. Rather, this should be done by separate legislation.

Reporting Requirements: We do not believe that the issue is as you perceive it - the assessment of penalties for the failure to report to the employee - but is, instead, what reports are due, when they are due, and what must be reported to whom. While the Department of Labor's proposed regulations would waive reporting requirements where the Employer has adopted the 5305-SEP, all other Employers would apparently have to report under regulations which have not yet been issued. The SEP is an IRA, established by the employee, which will accept contributions which are made by an Employer pursuant to a program which satisfies §408(k) of the Code. Based upon the instructions which accompany the the 5305-SEP, it appears that the IRS' only requirement will be for Employer to report the SEP contribution as income on a timely filed Form W-2. Are you suggesting that the Employer be required to prepare some additional report on an annual basis? This might be a bit of overkill. In addition, since this is an IRA account, the Trustee or Custodian will apparently be required to prepare the report created under IR-1673 which must be given to the participant by June 30th of each year.

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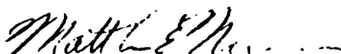
In Conclusion: We would like to reiterate our position that without the immediate passage of at least some parts of the TCA, the SEP is an unworkable product in fiscal 1979. The issues of social security withholding, contributions after age 70½, exclusion of certain union employees, etc. will, if addressed, permit the establishment of many of these plans. If new concepts are to be added, which would delay the passage of TCA, the overall result would be counter-productive. We suggest that these issues be addressed under separate legislation.

We respectfully submit our view that an alternative provision be adopted which would permit the individual to elect not to participate in the SEP, but to take the contribution as additional compensation. This change would eliminate the significant problems which we presented to the Committee in our written and oral comments. At the same time, this would be consistent with the "date of employment" concept found in the Joint Committee Report. Therefore, we see this as a technical and not substantive issue.

As we discussed, we would be more willing to meet with you, Mr. Nelton of your office, and Mr. Leiber from the staff of the Joint Committee on Taxation, to assist in the drafting of the final legislation in this area as well as offering any other assistance we can give to you.

Thank you very much.

Sincerely yours,



Matthew [illegible]
Technical Director

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SPECIALISTS IN MODERNIZING RETIREMENT PLAN SERVICES
INSTITUTIONAL PENSION CONSULTANTS

November 7, 1979

Mr. Chairman and Members of the Sub-Committee, my name is Matthew E. Newman. I am appearing on behalf of IPCO Incorporated, a New York based consulting company with offices in Washington, Massachusetts, and California, of which I am the Technical Director, and The National Retirement Plans Training Conference, Inc.,(NRPTC) a nation-wide Non-Profit Trade Association consisting of commercial banks, savings and loan institutions, mutual savings banks and credit unions. In these two capacities, I am here representing over one thousand institutions ranging in size from 2 1/2 million dollars in assets to over thirty billion dollars in assets.

Any statements that I make today are not the statements of any individual financial institution which is a member of the NRPTC nor any client of IPCO, Incorporated. Rather, they are based solely upon our experience providing services to financial institutions throughout the country. The point of our written comments and today's oral testimony is the Simplified Employee Pension Plan, SEP.

Financial institutions throughout the country are going through a period of rapid disintermediation of funds, a crisis of confidence and general problems for which legislative solutions are being sought. Money market funds, which virtually did not exist one year ago for the small saver, now have assets that total more than thirty billion dollars. They offer high rates of return, instant liquidity and function as if they were checking accounts for the individual who has relatively few dollars to invest. Just last week, the Senate passed the Depository Institutions Deregulation Act (HR4986) which among other things would grant new trust powers to federally chartered savings and loan associations, permit greater consumer loans and generally make more funds available at higher interest rates for all depositors. While these are necessary steps for the economy as a means of encouraging capital formation and dealing with the inflationary spiral, they do not address the issue of pension fund deposits as a key to institutional stability, savings growth, etc.

During the first six months of 1979, New York State mutual savings banks had a net deposit outflow of 1.84 billion dollars. In sharp contrast to this, during the same period, they had a net deposit inflow in pension funds of 329 million dollars, primarily in IRA and Keogh funds.(See Exhibit 1 indicating deposit trends for 1976, 1977, 1978 and the first six months of 1979). When the Revenue Act of 1978 was passed, the SEP was envisioned as a means of increasing private pension plan coverage, increasing savings and creating a simple pension plan for employers to adopt. Unfortunately, this has not occurred even though the IRS has just issued a new model form that Employers may adopt.

I am here today to stress the need for swift congressional action with respect to Simplified Employee Pension Plans (the SEP). Enacted by Section 152 of the Revenue Act of 1978, the SEP is an example of an excellent idea that is so good and so timely that it may succeed in spite of the problems that it apparently creates. While the Technical Corrections Act of 1979 which is before the Senate will deal with many of the problems such as Social Security Taxes, contributions for eligible individuals over the age of 70 1/2, exclusion of union employees, etc. which make the SEP unworkable now there are other issues which must be clarified if the SEP is to function as a reasonable alternative to the qualified plan in terms of the significant inflow of savings funds and the increased coverage of employees by the private pension system. . There are two major issues which must be addressed at this time:

1. Excess contributions over $1,750
2. Eligibility and what happens if one employee decides not to establish a SEP

Section 157(c) of the Revenue Act of 1978 added Section 408 (d)(5) to the Internal Revenue Code to deal with the tax consequences of an excess contribution into an Individual Retirement Account. This section of the Code deals with how and when there can be a withdrawl of an excess contribution and what the penalty taxes will be. It raised the dollar amount involved to $1,750 which corresponds to the maximum deduction for spousal IRAs under Section 220 of the Code. Unfortunately, the law does not recognize the issue of an inadvertant excess contribution in the case of the SEP which can be significantly more than $1,750. Section 408(d)(5) should be amended to permit an excess contribution in excess of $1,750 but less than $7,500 in the case of a SEP to be subject to the same rules as a regular or spousal IRA.

The more important issue concerns the problem of eligibility to open, fund and maintain the SEP when any one eligibile employee decides not to establish the SEP. There are many reasons why this could occur including religious reasons, desire and need to obtain these funds now, the desire to have a Spousal IRA, etc. Under the terms of the statute, the SEP must be established by the Employer in a uniform non-discriminatory manner and cover all employees who have attained the age of 25 years and have worked for at least three of the preceding five years. If one employee refuses to establish the SEP or cancels it by revoking his IRA, which is the means by which the SEP is established, the plan may fail for everyone. In the Guidelines to its Model Form 5305-SEP, the IRS states that "All eligibile employees must participate." Continuing, the form indicates that "...Contributions for a calendar year must be made on behalf of <u>all employees who have met the participation requirements</u>..."

From the Employer's point of view, this will be a problem in that while the Employer will still get a deduction for wages paid, the issue of social security and income tax withholding may create an administrative nightmare. While the IRS Model Form indicates that the employer may make the SEP a condition of employment, we would imagine that any employer would be reluctant to fire any an employee under such circumstances.

In the Questions and Answers to Form 5305-SEP, the IRS indicates that

"... Your employer may require that you become a participant in such an arrangement as a condition of employment...If one or more eligible employees do not participate and the employer attempts to establish a SEP-IRA agreement with the remaining employees, the resulting arrangement will not result in any tax advantage and may in fact result in adverse tax consequences to the participating employees."(Q &A,#8).

From the individual employee's point of view, the failure of one fellow employee to establish and maintain the SEP-IRA will result in the loss of his SEP deduction. Assuming that the Technical Corrections Act has become law in its current form, there would not have been any withholding for federal income tax purposes nor for Social Security Taxes (See the footnote to Form 5305-SEP which indicates that pending legislation would eliminate the FICA tax on the SEP contribution). The result is as follows:

1. Each employee will have an excess contribution into his IRA resulting in various penalty taxes imposed by the IRS.

2. Each employee will owe federal and state income taxes on wages for which no withholding took place. If the employer attempts to "catch-up" on withholding in any one pay period, this may mean that the employee will receive greatly reduced net wages for that pay period.

3. There will have to be a "catch-up" for FICA taxes. Since this respresents after tax dollars to the employee, this is a significant burden. From the employer's point of view, he may be in violation of the law in terms of not transmitting these funds when required to do so.

We would propose two alternative solutions to deal with this problem.

1. All SEP contribution be deemed to not be wages and thus be treated in a similar way as contributions to a qualified plans under Section 401 et al. of the Internal Revenue Code This would deal with the tax problems, the issues of state income tax treatment, etc. While this may be the ultimate answer to many of the SEP problems that we see, it does not deal with the eligibility problem.

2. The statute should be amended to permit any individual employee to elect to NOT participate in the SEP-IRA by receiving the funds in cash from the Employer. This concept has precedent in several areas of the Code; noteably where the Owner-Employee in a Keogh Plan must elect to participate in the Plan and in the so-called cash-option profit-sharing plans which permit this annual employee participant election.

We would suggest that each eligible employee be permitted to waive participation in the SEP-IRA by filing an appropriate waiver form with the Employer which would include an acknowledgement that the employee did this voluntarily, that he or she had received the same amount from the Employer as wages as if he or she had established and was participating in the SEP. Since the employee would now have income tax withholding taken out of these funds, as well as FICA, this would clearly indicate to the employee the tax advantages of participating in the SEP-IRA.

The waiver form should indicate that the employee received the form, had the opportunity to revoke it in a manner similar to revoking an IRA, that he or she received the funds as wages, the year for which the election is made and that taxes, etc. have been withheld on the wages.

If the employee does not establish the SEP-IRA, or revokes it prior to the Employer making the contribution for that year, then the employee will be deemed to have elected to not participate in the Plan. The Employer would then be obligated to pay the employee the SEP contribution in the form of wages. If the Employer cannot locate the employee, then the wage contribution would have to be made as if the individual had elected to not participate in the Plan.

While this is not the ideal situation to a complex issue, we believe that it is a practical one which works. It deals with the discrimination issue by insuring that all employees will receive the same percentage amount, whether into the SEP or in cash. From the Employer's point of view, he would prefer the SEP since it will not result in any FICA tax, which the wages would incur. It deals with the issue of one employee refusing to establish the SEP to the detriment of all other employees. It also deals with the unreachable employee or the case of the eligible employee who dies prior to establishing the SEP. In such a case, the SEP would fail for everyone else.

This is merely one of the issues that has prevented the SEP-IRA from attaining its potential. Without some immediate affirmative action by the Congress, both in terms of passing the Technical Corrections Act and legislation to deal with this problem, the SEP will not work fiscal 1979. Under separate cover, we are submitting additional written comments which we have published since the Revenue Act of 1978 was passed last fall. Hopefully, we will not have to wait another year for employers and employees to take advantage of the Simplified Employee Pension Plan.

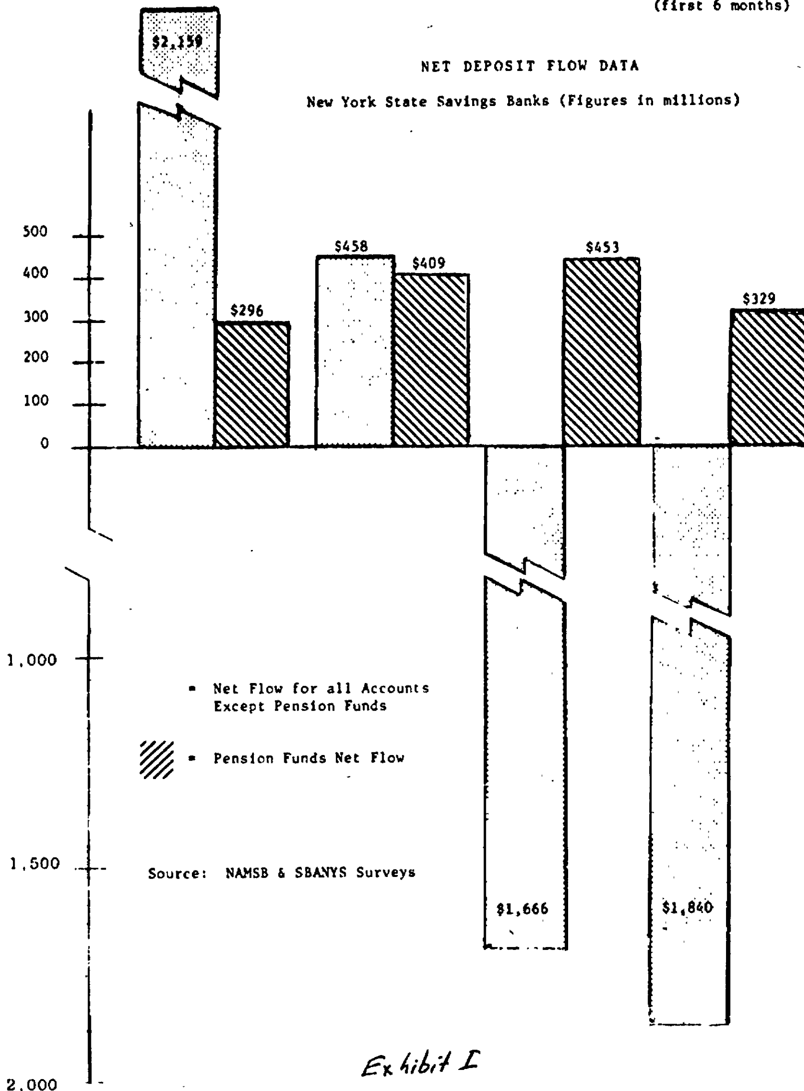

Exhibit I

Banking Industry
RETIREMENT PLANS
NEWS SERVICE

COVERAGE THAT IS COMPREHENSIVE
YET COMPREHENSIBLE

#78-21/22

THE SIMPLIFIED EMPLOYEE PENSION PLAN (SEPP) - A CASE OF FIRST IMPRESSION

Remember ERISA, that funny little bill that became law in 1974? Remember all the problems we had with the concept of IRAs created by that law; and how so many of those problems were resolved so effectively by amendments under the Revenue Act of 1978? While we were basking in the radiance of these changes, an evil little cloud almost slipped past us. The statute calls this little cloud a "simplified employee pension plan". Based upon the number of calls which we have received about this "wonderful" new concept, one might think that a STAR had appeared over §152 of the Revenue Act of 1978 (RA 78), where this provision is found. Through this article, we hope to show that its name is an anachronism. We will, therefore, use the term "SEPP" (one which your author does not like) to identify this odd creature of the Congressional imagination. Our leaders recognized a problem, tried to deal with it without a full appreciation of the ramifications of their approach, and fell on their proverbial seats. We anticipated these short comings when the concept was first introduced in the Bentsen bill (S-3140). [see our Issue #78-14/15/16, P.12)

Each time your author reads the aforementioned §152, he discovers many new questions and very few answers. We are afraid that this, as with the "mini-Keogh" and the "Spousal IRA", is just another case where Congress took a good idea and threw enough of a monkey wrench into it to kill it. Hopefully, the IRS will issue regulations in the immediate future, with respect to this type of plan, which will answer some of the questions.

The basic problem, as we see it, is that the SEPP is neither fish nor foul - it is not an IRA, nor is it a qualified plan....but something in between. Congress's approach was to take the existing

IN THIS ISSUE:

Season's Greetings

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IRA structure and use it as the foundation upon which to build. Remember the Employer IRA? That s the concept contained in §408(c) of the Code of which so few Employers have taken advantage. A SEPP is similar to an Employer IRA in that the Employer contributes to the employee s Simplified Plan.

Rules of the SEPP Are As Follows:

(1) Participation: All employees who have attained the age of 25 and who have performed service with the Employer during at least 3 of the immediately preceding 5 calendar years must be eligible to participate in a SEPP; and if the Employer makes any SEPP contributions for the year, must have contributions made by the Employer into their SEPP. In certain cases, the "Plan" may exclude union employees as well as non-resident aliens. However, the Congressional intent appears to have been that the SEPP into which the Employer will make those contributions will be established by each employee. If the employee refuses to establish the SEPP, it is very unclear as to what, if anything, will occur. [This may not necessarily mean that an employee is prohibited from establishing a SEPP and making his own contributions into it prior to his reaching age 25 or completing 3 years of service with the Employer. In any event, however, the Employer is not required to contribute into the Plan until those requirements are met.]

(2) Contributions: Contributions must be of a uniform percentage of compensation for all plan participants (Only the first $100,000 of any participant s annual compensation may be used as the basis for a contribution). However, Employer contributions into a SEPP are considered wages paid to the employee. This means that the Employer takes a deduction for the amount he contributes into the SEPP on behalf of the employee. The employee has this amount included in income and is then entitled to a deduction to the extent that the amounts contributed into the SEPP on his behalf by all his Employers during the year do not exceed 15% of his earned income, not to exceed $7,500. An important negative feature of the SEPP is that the Employer and the employee must both pay FICA (Social Security) and other payroll taxes on the Employer contributions, to the extent that the contributions, when added to the employee s other compensation from that Employer, do not exceed the Social Security Wage Base (which is $22,900 for 1979).

For Example: The Pitty Pat Plastics Corp. contributes 15% of compensation for 20 of its employees, each of whom earns $12,000 annually. The contribution on behalf of each of the employees is, therefore, $1,800. The full $36,000 (20 employees X $1,800 per employee) is subject to FICA. The FICA rate for 1979 is 6.13%.

(1) Employer Cost of 1979 SEPP contribution -	$36,000 X 6.13%	=	$2,206.80
(2) Aggregate Employee Cost of 1979 SEPP contribution -	36,000 X 6.13%	=	$2,206.80
	CO BINED ADDITIONAL COST	=	$4,413.60

(3) Vesting And Withdrawals: The Plan must provide full and immediate vesting of all Employer contributions. Also, the Employer cannot impose any restrictions on the withdrawal of funds from the SEPP by the employee. This will add some interesting considerations. any Employers who have establised Employer IRAs with no restrictions on withdrawals have found that typically many of these employees immediately withdraw the Employer s contribution. This adds greatly to the administrative burdens of the trustee or custodian institution. Since these funds are not of a long term nature, it detracts from the attractiveness of the Plan. The only impediment is the 10% premature distribution penalty, if the participant is under age 59 1/2; and the possible imposition of the early withdrawal penalty, if the account is invested in a CD.

(4) Written Formula: A SEPP is apparently created when the Employer effects a written document which establishes the rules with respect to participation, and a formula with which to determine the amount and method of allocating the Employer contributions.

(5) Social Security Integration: As we are all aware (more painfully so in 1979), a part of each employee s salary is withheld and paid over to the government as the employee s contribution into the Social Security fund toward his future benefit. Some of you may not realize, however, that the Employer is required to make a matching payment into the same Social Security fund. Since this payment is being made toward his employee s retirement benefit, the government allows the Employer to put provisions into certain types of retirement plans which take this type of "funding" into consideration. An Employer who establishes a SEPP may reduce the contribution he would otherwise make into the SEPP, by the amount paid into the employee s Social Security account for the year to which the SEPP contribution applies. If the Plan covers an owner-employee, the offset is only allowed if he makes a similar offset to the extent of his self-employment tax payment.

For Example: Dr. X decided to establish a SEPP for herself & her two lab assistants. The Plan provides for a 15% contribution on behalf of all participants with a full Social Security offset. The two employees earn $10,000 and $12,000 and the doctor s net profit (before contributions) is $42,000. The contribution on behalf of each employee is computed as follows:

	INCO E	NORMAL CONTRIBUTION (15% in this case)	Social* Security Tax	NET CONTRIBUTION
Employee A	$10,000	$1,500	$ 613	$ 887
Employee B	12,000	1,800	735	1,065
	$22,000	$3,300	$1,348	$1,952
Dr. X	$40,048	$6,007	1,855	4,152
		9,307	3,203	6,104

* NOTE: 1979 FICA tax on the common-law employee s wages: 6.13%
1979 Self-Employment Tax on the self-employed s net earnings: 8.10%

If a self-employed person were also receiving a salary as a common-law employee of another Employer, his self-employment tax is reduced to the extent that his other income is subject to FICA. The law, however, ignores the owner-employee s FICA covered income for purposes of integrating the SEPP. If this adjustment were allowed to be made for purposes of a SEPP, in most cases an owner-employee would get a disproportionately greater benefit. What if Dr. X (in the example above) was also an employee of a hospital, in addition to her private practice (the income upon which her self-employment tax is determined)? Had she been allowed to make this type of adjustment, she would be receiving a special benefit under her SEPP.

For Example: Dr. X s compensation from the hospital is $18,000 for 1979. Since she would be paying FICA on this amount, she would have a lower self-employment tax liability for the year. Were it not for the previously stated rule, DR. X would be entitled to a greater contribution into her SEPP.

Self-employed income	$40,048	
Amount of above subject to self-employment tax		$22,900
LESS: FICA taxable wages for 1979		18,000
Adjusted self-employed tax base		4,900
Self-employment tax rate		x.081
Self-employment tax		$ 397

As you can see, if the adjustment for FICA taxable wages were allowed to be made for this purpose, the owner-employee would receive a greater benefit. Rather than a deductible contribution of $4,152 in the previous example, she would be entitled to $5,610 resulting from the reduced adjustment from $1,855 to $397. Although an owner-employee is not allowed to take this adjustment into consideration, it should be noted that the adjustment would apply in the case of a self-employed individual with a 10% or less interest in a business.

New Complexities and Costs Introduced by the SEPP

As your author sees it, the basic problem is that the SEPP is an extension of the IRA. As you will recall, the IPC comments on this approach under the Bentsen bill were that these requirements should have been handled under §401 which deals with qualified plans, rather than under §408. In any event, there are several questions which immediately come to mind....

1) The first is, how will the accounts be established? The

Congressional intent was apparently for the Employer to contribute to the special IRA set up by the participating employee. Does this preclude the establishment of the Plan by an Employer or an Association under §408(c)?

2) The second question is, where will the employee accounts be established? ay all employee accounts be opened by the Employer at the same institution or will many accounts be opened at several banks, savings and loan associations, insurance companies, mutual funds, etc. This might be quite common in major metropolitan areas such as New York City where a large number of employees might wish to establish their accounts in institutions which are conveniently located near their residences. I m sure we don t have to tell you what this will mean with respect to paper work for the Employer.

3) What happens if each employee opens his individual SEPP at different times of the year? The SEPP may be established by the employee up to April 15th and a deduction taken by the employee for the preceding tax year. But if the Employer is a calendar year corporation, its tax return may have been filed prior to the establishment and funding of the employee s SEPP (tax returns for calendar year corporations are due by arch 15th). This may result in the Employer s return, upon which a deduction is allowed for the SEPP contribution, having to be amended.

4) Since contributions into the SEPP may be made after year-end for the previous year, additional problems come to mind. In such a case, in Year One (i.e. 1979), the year to which the SEPP contribution applies, the employee gets the deduction; but the contribution is considered income to him in Year Two (i.e. 1980), the year in which it is actually received. But what happens if the SEPP contribution for 1980, itself, is made in 1980. This is not only a headache for the Employer with respect to the filing of his tax return and the additional paper work involved, but it will become a problem for the employee as well.

For Example: Wing Soo s Wonderful Woks, a calendar year taxpayer, established a SEPP for all twenty of its employees in 1979 and agreed to contribute 15% of each employee s annual compensation of $12,000 into the Plan (therefore, the contribution on behalf of each employee is $1,800). Nineteen of the employees set up their individual SEPP s in December 1979, but the contributions were made after year-end. The twentieth employee (ei Ling Smith) opened her SEPP on April 1, 1980.

A. The employer deducted on its 1979 tax return, as additional wages, the sum of $34,200 (19 x the average contribution of $1,800) when it filed its tax return on arch 15th, 1980 (the due date for calendar year corporations). But, on April 1, 1980, it

must contribute an additional $1,800 to Mei Ling Smith's account. It must now amend its 1979 corporate return to show the contribution made to that one additional SEPP.

B. Each of the employees deducts the 1979 SEPP contribution on his own 1979 tax return, but the funds are considered income in the year received, 1980. In December of 1980, the corporation makes the same contribution to all 20 SEPPs for the 1980 year. The employees again take their deduction for the contributions made to their accounts for that year (1980). The amounts contributed once again become additional income in the year received, which in this case is 1980. BUT NOW, you have even more additional income in the same year, because of the doubling up. Let's take a look at this:

1979	Wages	$12,000	
	LESS 1979 SEPP deduction	(1,800)	
	Additional income in 1979 based on contributions received this year (1979)	0	
	1979 Adjusted Gross Income	$10,200	
1980	Wages	$12,000	
	LESS 1980 SEPP deduction	(1,800)	
	Additional income in 1980 based on SEPP Contributions received this year (1980)	1,800	(1979 contribution)
		1,800	(1980 contribution)
	1980 Adjusted Gross Income	$13,800	

While the total deductions for the two years match the increased income, the income and the deductions do not coincide for the two years. This means that the employee is showing more income on his taxes for the year 1980 than he actually received, and is being pushed into a higher tax bracket as a result.

5) Since the Employer must withhold the employee share of FICA (Social Security Tax) when the wages are paid, where will the money come from for employees who open their SEPP after year-end? When the Employer makes a contribution for the employee, he is actually giving each employee additional wages and must, therefore, withhold additional FICA to cover the wage increase. In order to give $1,800 to each employee, the Employer must withhold $110.34 ($1,800 X 6.13% the FICA rate for 1980). If there is a single check given at the end of the year, the Employer will have to reduce either the SEPP contribution or the employee's take home pay. Your author would not want

to have to be the person who explains to the employee why his weekly paycheck was reduced.

Since the Employer must withhold the employee's share, he has the choice of:

a) withholding the additional FICA from the employee's regular salary, assuming that the salary remaining to be paid exceeds the FICA withholding tax;

b) withholding it from the SEPP contribution itself, in which case the amount to be deducted by the employee would be the net amount which has been contributed into the SEPP (actual contribution less the FICA); or

c) paying the amount directly, which would in effect further increase the employee's compensation. It would also increase the amount the Employer agreed to contribute.

6) Those of you who were hoping to be able to begin establishing these plans early in 1979 by making a simple amendment to Article IX of your Form 5305 are in for a rude awakening. Article VII of Forms 5305 and 5305-A states that a person may make any amendment to an IRA by changing Article IX. It provides, however, that no such change shall amend Articles I, II, or III. Article I states that no contribution in excess of $1,500 shall be accepted into the account of a participant with respect to any taxable year. This means that a completely new document will be required. Our understanding is that the IRS will not be coming out with any forms until Spring.

7) It is extremely important to note that the employee's, and not the Employer's, contribution and deduction is limited to 15%, not to exceed $7,500. We will expand upon this consideration in a future article.

Let's Look At The Alternatives

Based upon its name, if the SEPP is truly a "simplified" plan, it must be simpler than something else. Because of its complexities, it is not simpler than either an IRA or a Keogh Plan, or even a Corporate Profit-Sharing Plan. What, then, is it simplier than?

(1) SEPP vs. The "Conventional" IRA:

Here, there is no simplification possible. With the elimination of the filing of Form 5329 (see News Service NO. 78-19/20), in most cases the SEPP reporting forms, when issued, will probably be more complex than the standard IRA. Since the IRA permits each individual employee to set up a plan if he chooses, there are no participation, contribution, withdrawal or reporting requirements for the Employer. It is important to remember that the conventional

IRA is primarily a tax shelter for the individual who is not covered by a plan. It is not a tool of employee benefit planning for the Employer.

The SEPP has broader limits than the conventional IRA because the contribution limits for the Employer to the Employee's SEPP are raised to the lesser of 15% of compensation, or $7,500. If the Employer doesn't take advantage of these new limits, the employee may establish his own IRA to fund the difference between the standard IRA limits (15% or $1,500) and the Employer's SEPP contribution. Since the Employer must adopt some sort of plan, keep records and file reports, we don't believe that the SEPP is simpler than the IRA for either the Employer or the employee.

(2) SEPP vs. Keogh Plan: Since the limits of the Defined Contribution Keogh Plan are generally the same as the SEPP, and since there may be additional restrictions and record-keeping requirements for the Employer without the flexibility of a Keogh Plan, we do not believe, except in a few cases, that the SEPP will replace the Keogh Plan. It might be advantageous where the owner-employee establishes an "integrated" SEPP (see below) and there are few, if any, common-law employees earning more than the Social Security Wage Base. Also, whereas employees working less than 1000 hours may be excluded from Keogh Plans, they may not be excluded from a SEPP.

(3) SEPP vs. Corporate Defined Contribution Plan: Compared to a conventional qualified plan, the "plan" to fund the various SEPPs will have rules with respect to participation, vesting, etc., but it will also have more restrictions on contributions, forfeitures, loans, etc. The SEPP is designed to be less flexible than a qualified plan. When the simplified reporting requirements are issued, it may be possible that the SEPP might replace certain qualified plans for ease of reporting, but we believe that the other considerations might outweigh even that benefit.

NOW LET'S LOOK AT THE GOOD SIDE:

(1) A contribution may be made to a SEPP by an Employer, even if the employee is a participant in another qualified pension or profit-sharing plan.

(2) If the Employer contribution to the SEPP does not equal the conventional IRA limits (15% not to exceed $1,500), the employee may make his own "catchup" contributions to fund up to those limits, so long as he is eligible to otherwise establish an IRA. This means that an individual who is covered under a qualified plan may have Employer contributions made into a SEPP, but is not allowed to have any "catchup" contributions.

3) As we previously pointed out, the SEPP may be very advantageous in the case where the Employer contribution is being offset by the Employer's FICA contribution. Let's change the Pitty Pat Plastics Corp., in the example on Page 2, to include the President who earns $100,000 per year (the maximum level of compensation taken

into consideration when making contributions to a SEPP).

Example I: Employer elects contribution of 7.5% --

(1)	20 employees at contribution rate of 7.5% (maximum) [20 X 12,000 X 7.5%] =	$18,000	71% of the total contribution
(2)	President at contribution rate of 7.5% (maximum) [1 X 100,000 X 7.5%] =	$ 7,500	29% of the total contribution
	TOTAL CONTRIBUTION	$25,000	

Example II: Employer elects SEPP contribution of 6.13% - (Less amount contributed for FICA)

(1)	20 Employees - (all earn less than the Wage Base)	$ 0	0% of the total contribution
(2)	President - $100,000 X 6.13% =	$ 6,130	
	less 6.13% X 22,900 =	1,403	100% of the total contribution
	TOTAL CONTRIBUTION	$4,727	

In this case, none of the employees earn over the Social Security Wage Base, therefore, there is no contribution required to be made on their behalf. Although the contribution on behalf of the owner is reduced from $7,500 t $4,727, the contribution for the employees is reduced from $18,000 to $0. Since the SEPP may be established regardless of other plans, this may be an attractive alternative to or supplement to a Defined Contribution Plan already in existence.

These are just a few of our problems with the SEPP. Since we anticipate regulations from the IRS in the immediate future, we intend to defer the rest of our analysis until the future issues of the News Service. Hopefully, some of these problems will have been solved.

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CONGRATULATIONS....

To DOROTHY JENSEN, Central Bank of Denver, on her promotion to Assistant Vice President, IRA/KEOGH Dept.

To BOWMAN N. TURPITT, Houston First Savings, on her promotion to Marketing Officer.

Anyone else who has recently received a promotion, please contact us so that we may announce it in our News Service.

Banking Industry
RETIREMENT PLANS
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COVERAGE THAT IS COMPREHENSIVE
YET COMPREHENSIBLE

No. 78-23/24

MORE ABOUT SIMPLIFIED EMPLOYEE PENSION PLANS (SEPPs)

Def: Simplify - Make simple, make easy or easier to do or understand. (Oxford Dictionary). . . ABC...that's simple! Dick meets Jane...that's simple! 1+1=2...that's simple! A Simplified Employee Pension Plan...that's not simple!!!

In our last issue we devoted a good deal of space to a discussion of the "Simple" concept of the SEPP, but had to limit ourselves in order to leave enough space to provide you with our Compliance Calendar. But, being the masochists that we are, we are returning to the rack. As you know, our motto is "comprehensive yet comprehensible". The SEPP, however, has stretched us to our limits. The article that follows is probably one of the most complex which we have ever written or which we will ever write.

Although our comments regarding the SEPP are very negative, we do not mean to suggest that you not offer the plans to your customers. You should, however, be conversant with the detriments as well as the benefits. We believe that even with the many problems involved, many employers will be adopting SEPPs under the present rules. However, not all of them will focus on these negative aspects until its too late. We hope that our endeavors to bring these considerations to the attention of Congress and the IRS will eliminate many of the problems before they get out of hand. Once again, we are satisfied that "simplified plans" would work if they were handled under the sections of the Code which deal with qualified plans (§401). We believe, however, that a new section of the Code dealing exclusively with these plans would be an even better alternative.

First, Let Us Deal With The Question of - What Amounts May be Contributed BY THE EMPLOYER Into A SEPP

IN THIS ISSUE:

KEOGH PROHIBITED TRANSACTIONS

KEOGH ROLLOVERS TO IRAs

TRANSFERS BETWEEN IRAs

BEWARE BAD IRS ADVICE!

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§415(e)(5), as amended, treats all SEPPs as defined contribution plans, subject to the 25% limitations of §415(c). Under this section, the annual limitation on the amount an employer may contribute into an employee's SEPP is 25% of that employee's compensation for the year.

Now, Let's Talk About Deductions

The deduction for SEPP contributions is covered in two different sections of the Code. One section deals with the deduction by the Employer, the other deals with the deduction by the participant. Remember, the employer's SEPP contributions are included in the employee's income. Rules covering THE EMPLOYER's DEDUCTION are in §404 of the Code.

WHEN ARE THE EMPLOYER'S CONTRIBUTIONS DEDUCTIBLE -

> "Contributions for a calendar year are deductible for the taxable year with which or within which the calendar year ends." (§404(h)(1)(A))

FOR EXAMPLE; Crystal Security Systems Inc. has an April 30th fiscal year. It establishes a SEPP in May 1979 (the first month of its 1979-1980 fiscal year). During the 1979 calendar year, it makes total contributions of $1,000 each month. Although it continues to make contributions for the months of January through April 1980, which is still in its 1979-1980 fiscal year, it will only be allowed to deduct the $800 contributed during the months of May through December 1979. The company will not be allowed to deduct the $400 contributed during the balance of their 1979-80 fiscal year until their 1980-81 fiscal year.

WHEN ARE THE EMPLOYER'S CONTRIBUTIONS DEEMED "MADE" -

> "Contributions made within 3 1/2 months after the close of a calendar year are treated as if they were made on the last day of such calendar year if they are made on account of such calendar year." (§404(h)(1)(B))

FOR EXAMPLE; Boing Spring Corporation establishes a SEPP on December 31, 1979. The corporation has a January 31st fiscal year. It makes a contribution on April 10, 1980 for the 1979 year (February 1, 1979-January 31, 1980). The contribution is deductible for the corporation's fiscal 1979 tax return. Note, however, that any contributions made after April 15th of any year will not be deductible by this employer until the following year, even if the corporation obtains an extension for filing its income tax return. It also appears that, whether a company is on a cash or an accrual method of accounting, the actual contribution must be made by April 15. It's interesting that Congress used "3 1/2 months after the close of the calendar year", rather than the due date for filing tax returns. Clearly, 3 1/2 months is April 15, but the due date for an individual's income tax return may be as late as April 17, where April 15 falls on a Saturday. We hope the IRS will take a liberal approach to this question in their regulations.

HOW MUCH OF THE EMPLOYER'S CONTRIBUTIONS MAY THE EMPLOYER DEDUCT -

> "The amount deductible in a taxable year for a simplified employee pension shall not exceed 15% of the compensation paid to the employees during the calendar year ending with or within the taxable year. The excess of the amount contributed over the amount deductible for a taxable year shall be deductible in the succeeding taxable years in order of time, subject to the 15% limit of the preceding sentence" (§404(h)(1)(C))

This seemingly straight-forward statement of law raises at least two questions. FIRST, does the limitation of 15% of the compensation paid to employees mean - the compensation paid to all employees, or does it apply only to the compensation of participating employees? If the former applies, we may see some interesting results.

FOR EXAMPLE: The Schu Shein Corporation establishes a SEPP for its employees which provides that contributions shall be made for eligible non-union employees at the rate of 25% of their compensation:

Employees	Status	Compensation	Contribution
Schubert Shein	non-union	$ 50,000	$ 7,500
Sylvia Shein (his wife)	non-union	30,000	7,500
Morton Lace	union	12,000	- 0 -
Stanley Sock	union	8,000	- 0 -
		$100,000	$15,000

If all employees' compensation ($100,000) is taken into consideration, then this employer may deduct the entire amount contributed ($15,000), since it falls within the limitation of 15% of all employee's compensation. This is another question which should be resolved by the regulations. Also, your immediate reaction to the example above might be that Sylvia has an excess contribution into her account, subject to a 6% penalty, since the amount contributed on her behalf exceeds 15% of her compensation ($30,000 times 15% = $4,500). Well...maybe. We will look at the question of whether it is an excess contribution in a moment when we deal with the employee's deduction (see page 5).

SECOND, on what is the limitation based in the case of a self-employed individual? A self-employed's compensation is his earned income. This means his share of the net profits, after adjustments for contributions made on behalf of common-law employees. A determination of a self-employed's net earnings will generally not be made, therefore, until after the end of the company's fiscal year. The statute limits the employer's deduction to 15% of the "compensation paid to employees during" the calendar year. The concept of "paid" is meaningless in the case of a self-employed individual, since his net earnings are determined irrespective of whether he actually receives any distribution of the net profits during the year. How then do we deal with an unincorporated business with a fiscal taxable year(?) What amount is paid

to a partner in such a firm during the fiscal year where he makes no withdrawal from profits? The most logical approach might be to treat the net earnings at the end of the accounting period as having been "paid during that year". This would also accommodate those partners who leave during the year and have short accounting periods. Still another item to be dealt with in the regulations....(This looks more and more like a job for Super-Regulator. You remember him! Faster than a speeding Congress, able to leap tall statutes in a single bound, more powerful than the legal profession, and all that....)

What Happens If a Participating Employee in a SEPP Is Also Covered Under The Same Employer's Profit-Sharing Plan?

The employer is generally allowed to deduct contributions into its profit-sharing plan, to the extent that they do not exceed 15% of the compensation of all employees covered under the profit-sharing plan. This limitation must be adjusted to the extent that contributions have been made on behalf of any employees under the SEPP, who are also covered under the profit-sharing plan.

FOR EXAMPLE: Skull & Bones Corp., a small pharmaceutical firm, maintains a profit-sharing plan into which it makes a contribution of 12% of each participant's total compensation. It also establishes a SEPP with a contribution of 6% and a FICA offset (see our last issue). Employee C is not eligible to participate in the profit-sharing plan.

Employee	Salary	12% percent P/S Cont.	Gross SEPP	Fica Adjust	Net SEPP	Combined Cont.	Ratio To Comp.
A	$100,000	$12,000	$6,000	$1,404	$4,596	$16,596	16.60%
B	75,000	9,000	4,500	1,404	3,096	12,096	16.13%
C	50,000	0	3,000	1,404	1,596	1,596	3.19%
D	40,000	4,800	2,400	1,404	996	5,796	14.49%
E	20,000	2,400	1,200	1,200	-	2,400	10.00%
F	15,000	1,800	900	900	-	1,800	10.00%
	$300,000	$30,000	$18,000	$7,716	$10,284	$40,284	13.43%
LESS Emp. C	50,000	0	3,000	1,404	1,596	1,596	3.19%
	$250,000	$30,000	$15,000	$6,312	$8,688	$38,688	15.48%

In the example above, the employer's profit-sharing deduction would be limited to 15% of the covered employees' compensation of $250,000, or $37,500; reduced by the deductible SEPP contribution ($8,688) made on behalf of those employees who are covered under the P/S plan. In this case, the amount which may be deducted for P/S contributions may not exceed $28,812 ($37,500 - $8,688). Since the amount contributed into the P/S plan for the year was $30,000, it will not be fully deductible by the employer in this year. However, the excess may be carried over and deducted in the following plan year, to the extent that it does not exceed the limits in that year. No similar adjustment is required if an employee who is covered under the SEPP is also covered under the employer's money-purchase pension plan. However, the 25% limitation on additions under §415, which we discussed above,

would apply. In other words, the amount contributed to a money-purchase plan does not have to be reduced by the amount contributed into a SEPP, even if the money-purchase plan contribution is being made on behalf of the same employee.

THERE ARE SPECIAL RULES FOR SELF-EMPLOYEDS.

If contributions are being made on behalf of a self-employed individual into a defined contribution Keogh Plan, (i.e., profit-sharing or money-purchase), the limitation on the amount which the employer may deduct with respect to those contributions is to be reduced by any contribution made by that employer on that self-employed's behalf into a SEPP. In other words, if the self-employed earned $50,000 for the year, the combined deductible amount allowed to be contributed between the defined contribution plan and a SEPP is $7,500 ($50,000 X 15%). If the employer contributed $2,500 into the self-employed's SEPP and $6,000 into the defined contribution plan, he could only deduct $5,000 of the $6,000 contributed into the defined contribution plan because of the priority established for the SEPP deduction.

If, on the other hand, contributions are being made on behalf of a self-employed individual into a defined benefit Keogh Plan (DBK), the benefit accrual under the DBK with respect to any year should apparently be determined under the "1.0 rule". This rule requires the normal benefit accrual with respect to the year to be adjusted, by applying a fraction equal to 1 minus a fraction equal to the amount contributed on the participant's behalf, divided by the maximum amount allowed to have been contributed on his behalf for the year. In simpler terms, let's say that the self-employed earned $50,000 for the year. If $2,500 is contributed to his SEPP, and $3,500 is contributed to his defined contribution plan, the combined amount would be $6,000. Since this is 4/5th of the amount which could have been contributed on his behalf ($7,500) into these plans, the benefit accrual for this participant for the year under a DBK would be limited to 1/5th of the amount otherwise allowable. Remember, the limitation in a DBK is not on the amount contributed, but on the benefit the employee will receive. The employer may deduct whatever amount he puts into the DBK, to the extent that it is determined actuarially that such amounts are required to satisfy the minimum funding standard under the law for that plan year.

One advantage of a SEPP over a conventional Keogh Profit-Sharing Plan is that Keogh Plan contributions must be made on behalf of common-law employees for all years in which there is a sufficient profit; while under a SEPP, similar to a corporate profit-sharing plan, the employer may determine from year to year whether he wants to make any contributions into the plan.

Rules Covering the PARTICIPANT's DEDUCTION Are In §219 Of The Code, As Amended

As we mentioned in our last issue, the employee must include in his income for the year all SEPP contributions made on his behalf by all

of his employers. He may then deduct all such amounts to the extent that they do not exceed 15% of his compensation, or $7,500. Earlier in this issue (P.3), we saw that it might be possible for an employer (The Schu Shein Corporation) to contribute more than 15% of an employee's (Sylvia Shein's) compensation into a SEPP (depending upon the IRS interpretation of the statute, with respect to whether the word "all" means all employees or only all participating employees). If the employer is allowed, under certain circumstances, to contribute more than 15% of an employee's compensation, then we must question whether such a contribution would result in an excess contribution for the employee; in this case, Sylvia.

According to the statute: "the limitation on the employee's deduction shall be the lesser of (A) 15% of the compensation includible in the employee's gross income for the taxable year (determined without regard to the employer contribution into the simplified employee pension), or (B) the amount contributed by the employer into the simplified employee pension and included in gross income (but not in excess of $7,500)". This language lends itself to several interpretations. If an individual is employed by several employers, is the limitation in (A), above, determined by taking into consideration the compensation from all employers, including those who have not established a SEPP? If so, an employer could contribute, on behalf of an employee, more than 15% of the amount he compensates that employee, without having created an excess contribution for that employee. This would be so, if that employee has compensation from other employers who do not themselves contribute into SEPPs; and so long as the amount contributed by this employer does not exceed 15% of the total compensation received from all of such employee's employers.

FOR EXAMPLE:

EMPLOYEE	COMPENSATION FROM THE SCHU SHEIN CORP.	COMPENSATION FROM THE TIDY TOES CORP.	SCHU SHEIN CORP's SEPP CONTRIBUTION
Sylvia Shein	$30,000	$20,000	$7,500

Although the Schu Shein Corporation's contribution into the SEPP is 25% of the compensation it pays to Sylvia ($7,500 ÷ $30,000 = 25%), it may not create an excess contribution for Sylvia if the law allows her to take all of the compensation received from all her employers into consideration, and so long as the SEPP contributions from all of her employers does not exceed 15% of her aggregate gross earnings of $50,000. ($30,000 plus $20,000 = $50,000 X 15% = $7,500) (instead of $30,000 X 15%, which only equals $4,500)

Another way to interpret the statute, however, is to say that the employee's deduction is limited on a per employer basis. This could mean two things:

1) The employee would be limited to a deduction of 15% of the compensation paid by the particular employer making the SEPP contribution, not to exceed $7,500, and would not be allowed to take into consideration any compensation received from any other employer.

this interpretation, any amount contributed by any one employer in excess of 15% of the compensation paid to the employee by that particular employer would not be deductible by the employee; and would, therefore, be an excess contribution.

2) If the $7,500 limitation is to be applied on a per employer basis, an employee working for several unrelated employers - all of which maintain SEPPs - could have amounts contributed on his behalf into the several SEPPs, and could deduct each of the SEPP contributions, which in the aggregate could exceed $7,500. In other words, the $7,500 would be the limit that the employee could deduct with respect to each employer's contribution, rather than the total amount which may be deducted by the employee with respect to amounts contributed by all his employers (i.e., Employer A could contribute $7,500, Employer B could contribute $7,500, etc., so long as no single employer contributed more than $7,500.) We do not believe that this was the Congressional intent.

- THESE ARE SIMPLIFIED PLANS ??? -

What About The OWNER-EMPLOYEE's Deduction?

Once again, there are special rules for owner-employees covered under a SEPP. The wording of this provision leaves much to be desired!!!

"In the case of an employee who is an officer, shareholder or, owner-employee described in §408(k)(3), the amount referred to in subparagraph (B) shall be reduced by the amount of tax taken into account with respect to such individual under subparagraph (D) of §408(k)(3)."

The Congressional Committee reports explain this provision simply by saying "In the case of an employee who is an officer or shareholder, or in the case of an owner-employee, the deduction limit is reduced if Social Security Taxes are treated as employer contributions."

The "amount referred to in subparagraph (B)" is "the amount contributed by the employer to the simplified employee pension and included in gross income (but not in excess of $7,500)". The amount actually contributed by the employer is only deductible to the extent that it exceeds the Social Security Tax taken into consideration. Let's say that Mr. Jones, an owner-employee earning $50,000, has a SEPP which provides for a 15% contribution which is reduced by Social Security Taxes paid on the participant's behalf for the year.

Self-Employment Income	$50,000	
Normal SEPP Contribution (15%)		$7,500
LESS: Self-Employment Tax ($22,900 X 8.1%)		1,855
Actual Net SEPP Contribution		$5,645

The $5,645 is included in Mr. Jones' income. Under one interpretation, Mr. Jones' deduction would be the amount contributed ($5,645)

(not in excess of $7,500), reduced by the Self-Employment Tax ($1,855). Therefore, although he would have to include the $5,645 in his income for the year, he would only be allowed to deduct $3,790 ($5,645 less $1,855) for that same year. We do not believe this was the Congressional intent.

We think the "amount referred to in subparagraph (B)" is the $7,500 dollar limitation contained in the parenthesis in the subparagraph, rather than the "amount contributed by the Employer". This lanquage was probably incorporated in order to avoid the occurrence of the following type of situation, which could result in an individual getting the full $7,500 deduction, although he had the $1,855 offset.

Self-Employment Income	$62,367	
SEPP Contribution - 15%		$9,355
LESS: Self-Employment Tax		1,855
Actual Net SEPP Contribution		$7,500

Let's take a look at three different self-employed individuals, whose plans provide for a 15% contribution reduced by the amount paid as Social Security Tax, and see the results we get from a literal interpretation. A literal reading appears to suggest that "the amount referred to in subparagraph (B)" is the amount of the employer's contribution ($5,645), not to exceed $7,500. In order to arrive at the employee's deduction, the $5,645 would be reduced by the Social Security Tax taken into account. We believe that this special limitation was devised instead to reduce the $7,500 limit, as you will see in the second part of this section.

SITUATION:

	Owner-Employee A	Owner-Employee B	Non-Owner Partner C
Income	$50,000	$74,734	$74,734
15% SEPP Contribution	$7,500	$11,210	$11,210
LESS self-employment tax	1,855	1,855	1,855
NET SEPP Contribution	$5,645	$ 9,355	$ 9,355

(Remember, EMPLOYERS' CONTRIBUTIONS ARE NOT LIMITED TO $7,500.) As the statute now reads, it would seem that we would compute each employee's deduction as follows:

Owner-Employee A: (lesser of amount contributed or $7,500) less (S.S.Tax)
(lesser of $5,645 or $7,500) - ($1,855)
$5,645 - $1,855 = $3,790

You will note that although Owner-Employee A has $5,645 included in income, his deduction is being limited to $3,790.

Owner-Employee B: (lesser of amount contributed or $7,500) less (S.S.Tax)
(lesser of $9,355 or $7,500) - ($1,855)
$7,500 - $1,855 = $5,645

You will note here too, that although Owner-Employee B has $7,500 included in income, his deduction is being limited to $5,645, although the $7,500 does not exceed the limit.

Non-Owner Partner C: (lesser of amount contributed or $7,500)
(lesser of $9,355 or $7,500) = $7,500

Note that the Social Security Tax inclusion rule does not apply to Non-Owner Partners, therefore their allowable deduction is not reduced by the S.S. Tax paid on their behalf.

We believe that the language of the statute should read: " . . . , the $7,500 limit referred to in subparagraph (B) shall be reduced by the amount of tax taken into account . . . ". This would provide the following results:

Owner-Employee A: Lesser of amount contributed or ($7,500 less S.S.Tax)
Lesser of $5,645 or ($7,500 - $1,855)
$5,645 or $5,645 = $5,645

Owner-Employee B: Lesser of amount contributed or ($7,500 less S.S.Tax)
Lesser of $9,355 or ($7,500 - $1,855)
$9,355 or $5,645 = $5,645

Non-Owner Partner C: Lesser of amount contributed or $7,500
Lesser of $9,355 or $7,500 = $7,500

Under our interpretation, the O/E's deduction would be limited to the amount actually contributed (not to exceed $7,500, reduced by the Social Security Tax taken into account). Since any amount contributed in excess of $7,500 would be an excess contribution subject to the 6% penalty, the employer's allocation formula should take this into consideration. Once again, if an individual is a 10% or less owner, he is not subject to this rule, and would, therefore, be entitled to a full $7,500 deduction. This could make SEPPs very attractive to larger partnerships; such as, law firms, accounting firms, etc.

Another item for possible consideration is that, in the case of either corporations or unincorporated businesses which operate as "related employers", as defined in the proposed regulations (31.3121 etc.) under the Social Security Amendment Act of 1977, there might be enumerable consequences which we have only begun to analyze. Such companies should probably sit down and review these at length before opting to establish a SEPP.

What about The State Income Tax Treatment of a SEPP?

This might be the most problematic area of all. Many state income tax laws do not presently recognize IRA deductions. Some specifically recognize them to the extent of $1,500. Others follow the federal statute to one extent or another. Employers should seriously consider the state tax impact before establishing such plans. Congress obviously ignored this when deciding to handle SEPPs as IRAs, rather than as qualified plans. If these were qualified plans, the state income tax treatment would be far more uniform on a national basis.

Once again, we plan to approach Congress during 1979 to ask them to

reconsider their approach. Each of you should have your counsel review your own state income tax laws. If your state will not recognize the employee deduction in full, these plans may have limited attractiveness for your customers. You may wish to consider writing your Congressional representative and make your thoughts known. Since we plan to contact Congressman Gibbons' staff shortly, your views might also be expressed to him. Perhaps, with a concerted effort, we may be able to correct the problems before they actually start to occur.

Did this article leave you thoroughly confused? Well, so are we! BUT in spite of the many impediments, we believe that the concept of the SIMPLIFIED EMPLOYEE PENSION PLAN will eventually revolutionize the pension industry. We still look forward to your "Letters to the Editor", and would welcome your thoughts on the SEPP, or on any other subject which you think might be of interest to our readers.

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BEEN SPUN AROUND LATELY? WATCH OUT FOR ERISA §408(d)

In recent months we have been receiving more and more inquiries from institutions which are becoming more aware of their fiduciary responsibilities. In this article, we will attempt to take you through the most contradictory provisions of ERISA without thoroughly confounding you.

We recently received an interesting question from a mid-western bank which is a member of the NRPTC. They have a customer whose mother owns some real estate which she is willing to sell to her son's KEOGH Plan trust. The question was whether such a sale would constitute a prohibited transaction. The customer's counsel felt that if the real property otherwise met the definition of "qualifying employee real property" as defined in §407(d)(4) of Title I of ERISA, it would be exempted from the prohibited transaction rules by the provisions of §408(e). §408(e) states that if, among other things, the plan is an individual account plan, it is not subject to the prohibited transaction rules.

Quite right! §408 generally provides the exemptions from the prohibited transaction rules of §§406 and 407. However, §408(d) is the exception to §408. In other words, its the exception to the exception!! This sub-section provides an <u>absolute</u> prohibition against the purchase or sale of property between a KEOGH Plan trust and an owner-employee, <u>or a member of his family</u>. In this case, therefore, the only way for such a sale to be permitted is for the parties to file an application for exemption with the Dept of Labor, which by the way has recently issued one such exemption.

a distribution from a qualified plan, part or all of it may be rolled over (tax free) into an IRA. The income tax laws of some states fail to recognize the rollover as a tax deferring event. In such a case the person would find that, although he has avoided paying current Federal income taxes, there is a current State income tax liability. In the case of rollover and other IRA contributions, this gets even more interesting where the person resides in one state and works in another which has a different tax treatment. In many such instances, the person is entitled to a credit in his home state for out of state taxes paid <u>that year</u>. Since the distribution might be taxable in both states at different times, part or all of such credit might be lost.

2. <u>Employer Contributions To Employer IRAs & SEPPs</u> - This may be the most serious negative consideration with respect to establishing these types of plans. The Federal Income Tax Law requires the employer to include the contributions he makes on behalf of his employees, in their income. It also allows the employee to claim a deduction for the amount (to the extent that it does not exceed the limitations set by law), which should offset the amount included in income. Many states do not allow a deduction for IRA contributions. This could mean that as much as $7,500 (in the case of a SEPP) could be included in one's State taxable income, with no offsetting deduction. Other states allow a deduction for IRA contributions, but many still limit the amount of the deduction to $1,500. Unless these states amend their laws, this could leave one with a non-deductible amount of as much as $6,000, where a SEPP has been used.

Among others, Alabama, the District of Columbia, Massachusetts, Mississippi and New Jersey do not permit contributions into an IRA as a deduction for State Income Tax purposes...Arkansas does not permit an IRA deduction for the non-working spouse. [NOTE: Even though we are talking here of IRAs, as an aside, we thought that since we are talking of certain State laws that differ from Federal laws, we would throw in the fact that California limits <u>Keogh</u> deductions to the pre-ERISA rules (10% or $2,500).]

3. <u>The Time For Establishing IRAs & Making Contributions</u> - The time for <u>contributing</u> into an IRA was moved from February 14th to the tax due date (April 15th) including extensions. This has raised an interesting question.

Since the Internal Revenue Code makes no reference anywhere to establishing IRAs after year-end, may a State argue that - even if its statute follows the Federal statutes, any account established after year-end will not qualify for the prior year? The only references to establishing IRAs after year-end previously appeared in IR-1809, which stated that IRAs could be opened up to February 14th; and the Congressional Committee Reports which accompanied the Revenue Act of 1978, which state that an IRA account may be <u>established</u> up to the date for making contributions (April 15th); and IR-2086 (See Page 6), which states that IRA accounts may be established up to the due date for filing the Federal Income Tax Return.

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—From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers and Associations.

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We have received a number of calls from NRPTC members who have advised us that their states intend to use February 14th as the cutoff date. We suggest that your state trade associations, or at least your institution's counsel, review this matter. The problem is, that while some states have adopted the Internal Revenue Code in its current form (including all additions, deletions and other changes), other states have adopted the Code as amended as of a certain date. In the latter cases, the changes in the Revenue Act of 1978 may not be applicable at the State tax level, unless their State Legislature has acted.

4. State vs. Federal Estate Taxes - The assets in a decedent's IRA are not includable in his Federal gross estate if he has named a beneficiary, and that beneficiary receives the distribution in the form of an annuity (36 or more months). This does not necessarily mean that the amount will be exempt for state death tax purposes. This is one more indication that anyone who establishes an IRA, especially the rollover type, should seek competent counsel.

5. SEPPs May Have Hidden Franchise, Payroll, and/or Unemployment Tax Effects - Corporations must pay a franchise or income tax which is usually based upon their income. Many states, however, have alternative taxes based upon the compensation which the employer pays to its employees. If this alternative produces a higher tax, which usually occurs in any year in which the corporation has had an operating loss, the corporation will have to pay (the higher) taxes based upon the alternative. If the employer has established a qualified plan, the contributions into the plan are not current compensation to his employees, and will not, therefore, have any effect on such a minimum. If, however, the employer contributes into an Employer IRA or a SEPP, the amount contributed is treated as additional compensation to those employees; and would, therefore, increase the alternative tax, which is based upon the amount of compensation. This is just another example of the disadvantage of the SEPP being an IRA.

Two recent developments should serve to further indicate the confusion, traps and problems that occur with reference to various State laws. They illustrate the need for your institution to keep current with respect not only to National, but to State and Local tax changes.

The Massachusetts Department of Revenue has announced that, starting with 1978 State Income Tax Returns, the entire amount of a lump-sum distribution from a qualified plan will be treated as ordinary income. This will be true even if part of the distribution is eligible for the capital gains treatment at the Federal level. [Massachusetts Technical Release 79-1; 1/30/79] Being different is nothing new in Massachusetts - it is one of the States which does not allow the IRA deduction for State Income Tax purposes.

The City of Philadelphia's Wage Tax has been held to apply to amounts contributed by employers to qualified plans where the participants have the right to take the cash each year or leave it in the plan. The participants were held to have constructively received all of the funds as compensation subject to taxation whether or not actually received. [Philadelphia Tax Ruling #78-5]

RETIREMENT PLANS NEWS SERVICE

The Trustee

Upon the termination of a plan, the trustee has no specific filing requirements. If the trust continues in existence, the trust relationship will continue between the employer and the trustee until such time as all of the assets have been distributed from the trust. At this point, the relationship will cease. The trustee should have some documentation on file to support the fact that the plan has been terminated.

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TECHNICAL CORRECTIONS ACT OF 1979 (TCA '79) CLARIFIES THE SEPP

Remember the Simplified Employee Pension Plan (SEPP), that simple idea that generated over 25 pages of text in our most recent newsletters. In February, we suggested that you "...give the SEPP time, it will eventually succeed." While the results are not in yet, the proposed changes under TCA '79 may solve some of the problems we have been anticipating with the SEPP.

(1) FICA AND FUTA. These "hidden" taxes make the SEPP extremely non-competitive compared to qualified corporate plans. Further, if the SEPP contribution was made at the end of the year, the problem of withholding to pay the employee's share could be extremely touchy. TCA '79 would amend the law so that these funds would not be subject to FICA and FUTA taxes. Until this bill is passed, it appears to us that these taxes will have to be withheld and paid. We expect that the IRS will issue a procedure for filing refund claims.

(2) OWNER-EMPLOYEE DEDUCTION. In our issue 78-23/24, pages 7 and 8, we raised the confusing issue of - what deductible contribution could be made for an owner-employee who wished to offset contributions by the self-employment tax. We won't try to address that issue again here, but as we had suggested, TCA '79 would change the statute to refer to the "$7,500 amount".

(3) SEPP CONTRIBUTION AFTER 70½: Under the regular rules for an IRA, no deductible contributions may be made beginning in the year in which the individual attains age 70½ [§219(b)(3)]. But, the SEPP would require Employer contributions regardless of the employee's age. TCA '79 would allow the employee to deduct the Employer's post 70½ contributions in the case of the SEPP. We assume that, like Keogh contributions on behalf of an owner-employee who has attained the age 70½, these IRA contributions would purchase an immediate annuity.

IPC will be making comments to the Ways and Means Select Revenue Measures Subcommittee. Other areas of TCA '79 deal with (1) excess contributions, (2) Subchapter S Corporations, (3) SEPPs and Defined Benefit Keogh Plans, (4) Spousal Rollovers, (5) extensions of certain transitional rules for IRAs, and (6) Rollovers from §403(b) annuities. [Editor's Note: We were surprised to hear that another publication which some of you receive, recently advised its readers to rush into the SEPP immediately; and not to wait for regulations, or at least until the smoke has otherwise cleared. We usually make it a point not to criticize the Editorial Comments of other publishing and consulting firms, but we do feel that in this case, total disregard of the obvious confusion that exists may lead to embarrassing results. As a matter of fact, we will be covering another interpretation of an important SEPP concept in our next issue. We have been advised by a reliable source in Washington that anyone who proceeds before something is issued by the IRS, does so at his/her own risk.]

Our conclusion is that these changes, plus others that we feel are necessary, will occur in 1979 and will make the SEPP an extremely competitive product. Although NRPTC had developed and has submitted to IRS a prototype SEPP, which we believe answers or avoids most of these problems, we still feel that you should begin marketing these plans cautiously.

****

Private Letter Rulings "Liberalize" IRA Rules

As we are all aware, an individual who participated in a "qualified" plan for any part of a year is barred from deducting a contribution to an IRA for that year. (This blanket rule was relaxed under TRA '76 to take into account special cases involving members of reserve units of the armed forces, and volunteer firemen.) Even though an individual may not have accrued any vested rights in the plan; may have only participated for a short period of time; or may have had nothing added to his account in a profit-sharing plan, he or she might not be eligible to contribute to an IRA for that year.

Attempts to deal with these situations have given rise to the deductible employee contribution section of the SEPP, the Dole-Nelson Bill, the Limited Employee Retirement Account, etc. Three recent Private Letter Rulings, which may not be cited as precedent, nor relied upon, have addressed the issue of the plan participant in a Profit-Sharing Plan.

In PLR-7740008, the IRS ruled that if a Profit-Sharing Plan was terminated during the year, so long as no employer contributions were made that year on behalf of plan participants, such individuals would not be considered "active participants" for that year. The employees could, therefore, establish an IRA for that year, and make deductible contributions.

the employee will be considered an active participant and will not be allowed to contribute to an IRA, even though the amount contributed to his account added up to very little. BUT if the plan were amended to permit Ed to choose not to participate, he could give up the $14.00 contribution, to obtain a potential $1,500 IRA deduction!!

* * * * *

STEP ALONG WITH SEPP

We recently had some very revealing conversations with some very knowledgeable folks in our nation's capitol. They suggested an interpretation of a SEPP law provision which we had not anticipated. If they are correct, we forsee serious problems. The statement was made that, although the SEPP must be established by an employer's individual employees, failure on the part of one eligible employee to establish the SEPP may disqualify the program for <u>all employees of that employer</u>.

WHAT DOES ALL THIS MEAN? Let's say, for example, that Bonzo's Bongo Drums, Inc. established a SEPP for its twelve employees. The company decides to integrate the plan with Social Security. One of the employees, Xavier, will only be entitled to a $30.00 contribution for the year. Since Xavier's wife does not work, he could establish a Spousal IRA under which he would be entitled to contribute and deduct $1,750. If Xavier refuses to establish the SEPP, the employer will be entitled to a deduction for his contribution into the SEPP, but the employees would have to include it in income without any offsetting deduction. Although there are ways to deal with this problem, it may be just one more mess we may have to concern ourselves with. In any event, we won't know until regulations are issued, and that may not be until sometime in the Fall.

* * * * *

IRS SEEKS INPUT FOR CHANGES IN THEIR FORMS

As part of its annual review process, the IRS is seeking written comments/suggestions by June 1, 1979 for "improving" its instructions, forms, etc. We may prepare comments/suggestions for the June 1 deadline. Any comments and/or suggestions you have would be welcomed by your author. We will attempt to include them in our presentation.

* * * * *

IPC NEWS:

CHANGE IN OUR MASTHEAD - If you haven't already noticed, we have changed the title of this publication to reflect the fact that our service is read not only by commercial banks, but by thrift institutions as well. Although the trend has been to remove the distinctions that exist between the segments of the industry, we do recognize these distinctions and will continue to deal with them where appropriate.

THE OPERATIONS MANUAL - At long last, all of the delays which we have faced in putting together the new Financial Institutions Retirement Plans Operation Manual are behind us, and the manuals are in the mail. Any NRPIC member who has not received a manual within the next 3 weeks should contact Dorothy Wilens at 889-5873.

Financial Institutions
RETIREMENT PLANS
NEWS SERVICE

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JUNE 1979

REVISED FORM 5305, 5305-A ISSUED

The Internal Revenue Service has just released the Form 5305, Individual Retirement Trust Account, and Form 5305-A, Individual Retirement Custodial Account for 1979. The new Model Forms and Instructions (Rev. May 1979), which replace the 1975 version, include significant additions, deletions and changes from the documents which your institution has been using. There are changes in the official instructions, as well as in the Forms themselves. The ability to use Article IX to change, add, delete or modify the basic document, however, has been retained.

Instructions

In the instructions portion, the following should be noted:

General Instructions:

1. The second full paragraph clearly indicates that the individual has until the due date for filing his/her Federal Income Tax Return, with extensions, to establish the account and to make a deductible contribution for his/her prior taxable year. This change is consistent with the Revenue Act of 1978 and IR-2086, Questions and Answers About Individual Retirement Accounts. (See our February 1979 Issue, pp. 6 and 7.) For those of you who noticed the use of "his/her" instead of the masculine gender, the Model Forms have been changed to be sexless by referring throughout to "his/her".

IN THIS ISSUE:

NEW SAVINGS RATES EFFECTIVE JULY 1st

SPOTLIGHT ON NRPTC

ROLLOVERS AFTER AGE 70 1/2

2. The entire discussion of the deductibility of contributions, as well as the reference to the filing of the Form 5329, has been deleted from the general instructions.

Spousal IRAs:

1. This is a new section. Spousal IRAs are addressed in the Model Forms for the first time. Considering the fact that

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Spousal IRAs were first permitted under the terms of the Tax Reform Act of 1976, we can only say, "better late than never". The instructions indicate that Form 5305/5035-A may be used to establish either a Trust or Custodial Account on behalf of a non-working Spouse.

Definitions:

1. The term "Depositor" is defined to be "the person who establishes the account". Since the new forms will accept deposits to a Simplified Employee Pension Plan under §408(k), it would appear that our past interpretation, that the individual employee (and not the employer) must open and establish the IRA-SEPP, is correct. To put it more precisely, the employer will not be able to open the IRA-SEPP in the name of the participating employee.

A literal reading of this new definition could provide some problems in its practical application. For example; if the "Depositor" is both the one who establishes the account and the one who desires to provide for his/her retirement, is it now impossible for one spouse to use this Form to establish a Spousal IRA on behalf of the other spouse, as appears to be allowed under the IRS Questions and Answers in IR-1809? This may merely be an oversight on the part of the IRS forms design technical staff.

This language also suggests that an employer who wishes to make contributions on behalf of all his employees, but who does not wish to utilize the formal Employer IRA approach, which would subject him to Title I Reporting and Disclosure Requirements, might be precluded from using this Form to "establish" such accounts on behalf of his employees.

2. The definition of "eligible individuals", which was included in the 1975 forms, is not included in the new Forms. Perhaps this is so because no one is really certain as to who is eligible, since it is not yet totally clear who is an "active participant" in a Plan. Proposed regulations covering this subject were issued in March, with hearings set for July 19, 1979. (IPC has been actively reviewing these proposals for possible comment. Should you wish to make comments at the public hearings in Washington, you must submit an outline of your oral comments by July 5, 1979 to the Commissioner of IRS, Att: CC:LR:T(EE-18-78), Washington, D.C. 20224.)

3. The Forms also include no information concerning excess contributions and premature distributions, both of which were discussed in the 1975 forms.

Specific Instructions:

1. Article IX permits the Depositor and the Trustee/Custodian to incorporate additional provisions to the IRA. By specifically stating that these may include "state law requirements", the Forms recognize the fact that each state has the right to, and often does, treat the IRA differently for state income and estate tax purposes. It is our view that the disclosure statement, rather than this Form, should address the State tax issue. Since "Fees" are also specifically

mentioned, it is our belief that if you intend to impose penalties on time deposit accounts, for withdrawals prior to maturity by persons who have already reached age 59½ or older, you may wish to provide for the inclusion of appropriate language in your Article IX.

Document Provisions

In the Forms themselves, the following should be noted:

1. As a point of information only, if the Form is an amendment of a prior form, a special box is provided and is to be checked. However, in checking this box, your institution should be prepared to answer the Depositor's questions as to what has been amended, and when and how it will affect him.

Witnesseth:

1. There is no major change in this section except for the formal statement that the Trustee/Custodian has furnished the Depositor with a Disclosure Statement pursuant to §408(i) of the Code. NRPTC members will be receiving updated Model Financial Disclosure Material reflecting new certificate penalties as soon as they can be prepared.

Article I:

There are two major changes in this section which affect Rollovers and IRA-SEPPs. We also see an area of possible confusion which may limit your institution's use of these Forms.

1. As we have stated before, the new liberal Rollover provisions of the Tax Reform Act of 1976 and the Revenue Act of 1978 technically could not be used in conjunction with the 1975 version of the forms. The old Article I had limited contributions into the account to $1500, except for the specific Rollover exceptions set forth in the forms. Rollovers from a §403(b) Annuity, as authorized by RA'78, were not provided for in the 1975 forms. Moreover, while Article IX permitted you to amend the plan, Article VII stated that "the provisions of Articles I through III and this sentence shall be controlling". Since Article I in the old form limited annual contributions on behalf of the Depositor to $1500, and failed to mention Rollovers from §403(b) plans, a §403(b) plan distribution in excess of $1500, technically, could not have been rolled over through the use of the old forms.

Although, under the new Form, Article 1 now adds §403(b)(8) Rollovers, it does NOT specifically authorize Rollovers by a surviving spouse of a participant in a qualified plan, as recently allowed under RA'78. This type of Rollover may represent a major source of deposits for your institution. While the language of §402(a)(7)(B) refers to §402(a)(5) and may be interpreted as permitting this type of Rollover under the Model Forms, this is something your counsel should carefully review. We believe the Service should have had more foresight and should have referred to Rollovers by the current statutory authority as well as by any new statutory provisions as they are enacted. This would eliminate the need for new forms with each statutory change in this area.

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JULY
JUNE 1979

IRAs AND KEOGHs--ARE THEY WORTH ALL THE TROUBLE? .... YES!

When the American public looks at its financial institutions, it sees an industry which it assumes to be extremely sophisticated. After all, an industry so responsible for the economic lifeline of our nation must be very sophisticated. Unfortunately, this image is only partially correct. Fortunately for us, however, good business sense and strict regulations protect the assets of our customers, since our industry on the whole has not always approached new products, services, or ventures from a very scientific point of view.

IPC's publications and seminars have often raised issues about retirement accounts that might be of concern to institutions and customers alike. This was done, not to scare them out of the business, but to alert them to the pitfalls. IPC's editorial staff now feels that it's time to write an article which is totally upbeat, and encouraging. After all, if too many institutions are scared out of the business, there will be no one to write to.

Cost of Money - The management of many thrift institutions shy away from offering IRA and Keogh accounts because they feel the rates which must be paid on such accounts are generally higher than the rates which they would be paying on non-retirement plan accounts. Although we do not have statistics which are satisfactory in this regard, we have found through informal discussions held with many of our financial institution customers that these accounts are different from other accounts maintained in financial institutions; both in terms of the average amount on deposit and the staying power of the funds.

Savings & Loan News recently released a market study which

IN THIS ISSUE:

DEFINED BENEFIT KEOGH PLANS OPENS A NEW CUSTOMER MARKET

IRS ISSUES 1977 IRA STATISTICS

IPC OPENS WEST COAST OFFICE

EDITORIAL COMMENTS - BENTSEN, TRIBLE, GIBBONS-PICKLE BILLS; NEW FORM 5500-R, REVISED FORMS 5500, 5500-C, 5500-K; PUBLICATIONS 590 & 1048

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provides certain insight into IRA and Keogh deposits. Their study is important primarily because the savings and loan industry maintains a substantial portion of the total IRA and Keogh deposits in this nation. The study reflected the actual amount on deposit as of December 31, 1977 in both IRA and Keogh accounts, as well as the projected amount through December 31, 1979. As of the end of 1977, savings and loan IRA and Keogh composites totalled approximately $4.3 Billion. The average association at that time had approximately 285 IRA accounts and approximately 125 Keogh accounts. IRA deposits averaged roughly $2,800 while Keogh accounts averaged roughly $5,700. 60% of the institutions with assets of $25 Million or less offered IRA accounts, while 97% of the institutions with assets over $100 Million offered these accounts. 20% of the institutions with assets of $25 Million or less offered Keogh accounts, while 86% with assets over $100 Million offered these accounts.

When these institutions were asked to project their figures through December 31, 1979, they indicated that they expected the average IRA account balance to increase from the aforementioned $2,800 to almost $3,100, while Keogh accounts would increase from $5,700 to slightly over $6,200. The reasonableness of these projections is questionable when you consider the activity that has taken place in IRA accounts over the last several years. The NRPTC will be conducting a survey during 1979 to attempt to ascertain a more accurate figure with respect to the balances in these accounts as of April 15, 1979. In general, IRA and Keogh deposits have a tendency not to be subject to disintermediation. Caution should be observed, however, in assuming that these funds are totally free from disintermediation.

In some market areas a number of institutions have begun offering these accounts as 6 month certificates. The tendency in these particular accounts will probably be toward more rapid disintermediation than with respect to other retirement plan accounts which have been invested in longer term certificates. Once a person has selected a thrift institution as a medium of funding for his retirement savings, there is a tendency towards inertia. These people will generally leave the funds with the same financial institution unless they relocate prior to the point in time when they begin taking distributions from the account. Since these funds have a tendency to be more stable, the true cost of money is generally less than for other types of savings accounts which ostensibly pay the same rate. Non-retirement plan accounts which have been invested in 8 year certificates are really medium term certificates, since they are more prone to disintermediation if higher rates prevail at their maturity. 3 to 8 year IRA or Keogh certificates may be viewed as long term instruments because, notwithstanding their shorter term, the funds have better staying power.

The industry has been experiencing increased depositor sophistication, to the point where more depositors are leaning toward longer term, higher rate instruments. Many institutions are now advertising to retain or increase their deposits with respect to their normal savings activities. Far less advertising is required in

order to either maintain or to increase retirement plan deposits. The most important criterion for retaining these funds is not necessarily earnings rates, but convenience and satisfactory service.

One important phenomenon which has resulted in increasing the cost of money has been the tendency on the part of many institutions to make across-the-board rate increases when the maximum allowable savings rate goes up. Many of them have done this however, to minimize the cost otherwise anticipated by having to handle multiple accounts.

Growth Of Money - What are the potentials? That depends on your market place. But ... Let's play with some numbers for a moment.

Type of Account	Annual Contribution	30 year Cumulative	Term-End Value	25 Yr. Payout	Total on Deposit
IRA	$ 1,500	$ 45,000	$ 77,115	$ 7,427	$ 185,684
KEOGH/SEPP	7,500	225,000	385,574	37,137	928,416
CORPORATE	15,000	450,000	771,150	72,273	1,856,845

What might this mean to your institution? Let's say that you pick up 100 new IRA accounts each year, 50 new Keogh or SEPP accounts, and 5 new corporate accounts. Let's further say that you solicit new accounts for 10 years and then stop.

Type of Account	Annual Contribution	Annual Growth	Contributions in 10 years	Value in 10 years	Value in 20 years
IRA	$ 1,500	100	$ 8,250,000	$11,589,000	$ 49,698,000
KEOGH/SEPP	7,500	50	20,625,000	28,973,000	124,245,000
CORPORATE	15,000	10	8,250,000	11,589,000	49,698,000

Even with this modest growth pattern, after 10 years your IRA accounts have accumulated to $11.6 Million. If contributions continue to the original accounts, even if no new IRA accounts are opened after that, these accounts will be worth almost $50 Million after 20 years.

Impressed? Well let's look at your Keogh accounts. If contributions continue only to the accounts opened during the first 10 years, they would be worth almost $29 Million after 10 years. And almost $125 Million after 20 years. Is it worth it? You decide!!!

****

LETTERS TO THE EDITOR

We would like to thank Mr. Jack A. Marshall, Marketing Director of the Savings Banks Association of Massachusetts for the following letter -

> If there is an award for courage in talking to savings banker audiences, I think you should be a candidate for this year's award. Make that an award for courage and generosity.
>
> Naturally, I thank you for your generous contribution of time and talent to the success of our May 8th program. However, I think you made a masterful presentation about SEPP in the face of the lack of any difinitive direction from IRS. And that was an awesome display of courage combined with very creative professional insights.
>
> You sent our savings bankers away feeling that they had received the most up-to-date information available, and also feeling that for the first time they had some understanding of the problems SEPP currently has, and of why it really isn't all as simple as some would make it.
>
> So , I do thank you on many counts.
> Best wishes,

TECHNICAL CORRECTIONS ACT of 1979 PASSES THE HOUSE!!!

As we went to press, the House of Representatives passed TCA '79 and sent it on to the Senate. Many important changes that should be made, and which are necessary for the IRA-SEPP to be a viable product, were included in the House Bill. TCA '79 deals with such fundamental issues as Social Security Tax Withholding, the Owner-Employee deduction, and the SEPP contribution after age 70½. (See the March '79 News Service for detailed comments.) We will follow HR2797 in the Senate so that you will be informed as to the final changes and when they will become effective.

IN THE NEWS - NRPTC PROFILES - In our last issue, we promised to give you some highlights on some of those people who are serving on the NRPTC Board of Directors. THIS IS THE FIRST -- MORE TO FOLLOW

CHAIRMAN OF THE BOARD - Charles I. Pearman, who was elected Chairman of the NRPTC board, is an Assistant Vice President with the Home Federal Savings and Loan Association of Nashville, Tenn. He is married and the father of two lovely children. He received his B.S. at David Lipscomb College and his M.A. at George Peabody. Prior to his joining Home Federal, he was employed by his old alma mata, David Lipscomb College. He is also a board member of the Tennessee Savings & Loan Leadership Conference, and continues to teach at the Institute of Financial Education where he serves as Second V.P.

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September 1979

IRS RELEASES MODEL SIMPLIFIED EMPLOYEE PENSION (SEP) FORM

-- Hey, Hugo!

-- Yeah, Max.

-- Didja hear? The IRS has finally finished getting its forms together for that Simple Employee Plan.

-- What Simple Employee Plan?

-- You remember, dontcha? That's the thing that the government passed that lets companies like yours and mine set up simple pension plans for our employees.

-- Oh yeah. I saw an ad about that last month. This bank said that they had them, but when I called they sounded kinda confused.

-- I'm not surprised. My wife runs the retirement plans department over at the S&L and she said that she read in some newsletter that she gets (guess which) that she should wait until the government understands it better and comes out with some guidelines.

-- So now they did, huh?

-- Well, I'm not sure. The company that writes that newsletter that my wife gets says now there may be even more confusion.

-- Is that right Max? Boy, the fun may be just beginning.

IN THIS ISSUE:

NEW 5305-SEP FORM

STRANGE KEOGH RULE IS TAX TRAP FOR SOME PARTNERS

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Ever since the passage of the Revenue Act of 1978, under which the concept of the Simplified Employee Pension Plan was given life, our publication has been trying to keep on top of its development. Although we have been calling it SEPP up until now, we'll knuckle under and begin calling it SEP. We have tried to identify many of the issues in the hope that either Congress or the IRS, or both, would solve the problems and provide the answers to the

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questions. Although the new IRS Model Form 5305-SEP does answer some questions, it doesn't solve many problems. We anticipate that the IRS will soon come out with an Information Release, or some other missile which will provide some guidance. Before you vent your emotions on the IRS, however, you should focus on the real culprit. It was Congress that created this monster, which it is now asking its regulatory authority to dress up in party clothes. But like the "Hulk", we expect that it will not stay confined too long. It will get angry, begin turning green and bust right out of its clothes. Rather than continue this charade, the "powers that be" should spend more time searching for the serum which will bring about the cure.

Let's review the formal requirements for a SEP which are contained in Code §408(j), and see just how the IRS has attempted to dress up this creature.

Under the law, a SEP is made up of two components:

1. The FIRST is an IRA established by an employee, which contains language which allows it to accept Simplified Employee Pension contributions. The IRA document will generally be either an IRS Form 5305 or 5305-A, or it may be a prototype plan submitted by a sponsoring organization.

2. The SECOND COMPONENT is a written allocation formula prepared by the Employer who establishes such a program on behalf of its employees.

The IRS has addressed the requirements of the FIRST COMPONENT by amending the model Form 5305 so that it now contains language suitable for the acceptance of SEP contributions. (See the June 1979 issue of the News Service, pages 3 and 4.)

The SECOND COMPONENT has been dealt with by the IRS by their introduction of the new model Form 5305-SEP. Although we understand that this form may not yet be generally available at all IRS District Offices, we have been able to obtain a copy which we have reproduced for you at the end of this article. Note: The Department of Labor has issued Proposed Regulations relating to an alternative means of complying with the Reporting and Disclosure Requirements under Title I of ERISA for SEPs created by using the IRS Form 5305-SEP. The proposed DOL Regs are not applicable in any other case. We will address this issue prior to the final comment date; at which time we will refer to some new concepts which the DOL has created.

First, we will make a few general observations about the Form 5305-SEP. These will be followed by more detailed comments and a copy of the actual form. (Also see Issue 78-21/22 of the News Service) The references below in parentheses are to sections of the SEP article in that issue.

A. Social Security Integration Is Not Available - Although the law allows a SEP to be integrated with Social Security, the Employer may not use the 5305-SEP to accomplish this. (Page 3, #5)

B. No Other Plan - Although the law allows an Employer to establish a SEP in conjunction with his pension or profit-sharing plans, the Employer may not do so if he uses Model Form 5305-SEP. (P8, #1)

C. All Eligible Employees Must Establish the SEP - Apparently our views concerning this question some time ago were accurate (P2, #1). If one eligible employee decides not to establish his own SEP account, the Employer's plan will fail. The Form 5305-SEP indicates, however, that the Employer may require-as a condition of employment-that the employee establish the SEP account.

Analysis and Comments on Model IRS Form 5305-SEP:

I. GENERAL INFORMATION

Paragraph 1 sets forth some of the limitations on the use of this IRS Model Form. The Form may not be used if (1) the Employer currently maintains any other qualified plan or (2) ever had a Defined Benefit Plan in the past. It sets forth the rule that all eligible employees must establish their own IRA if the SEP is to be permitted.

There is language in the second paragraph which is confusing at best. The IRA-SEP contribution must be made into an IRA established by the individual employee. A Spousal IRA is established either by or for a non-working spouse under §220 of the Code. An Employer may make a contribution into a spouse's account, and the amount would be included in the employee's taxable income. The employee could not, however, claim a deduction under §219 for a SEP contribution of an Employer if he is claiming a deduction under §220 for a contribution made into his spouse's IRA. It seems to us that this is much ado about nothing. The average Employer is not going to be making contributions into the accounts of its employees' spouses. The only really significant statement in this paragraph is that the making of contributions by the Employer into the account of an employee's spouse will not disqualify the Employer's program. (Also see Item #7 in the Questions and Answer section of this article.)

Apparently, neither the IRS nor the DOL has yet decided what type of Plan the SEP will be. Employer IRAs currently are required to file either Form 5500 or 5500-C. If the intent is to simplify reporting and disclosure, the filing of either the 5500 or the 5500-C, including the new proposed 5500-R triennial reporting, would apparently result in no less difficult a reporting task than the filing generally required for HR-10, Employer-IRA or Corporate Plans.

The footnote to the General Information section points out the Social Security tax problem which your authors raised when the SEP was first enacted. While the Technical Corrections Act has passed the House, it has not yet passed the Senate!!!

THE MOST SERIOUS DEVELOPMENT may be the position taken by the IRS with reference to the year in which the SEP contribution will be

included in income. The IRS may be biting off more than it can chew. If the Employer's contribution is made during the calendar year to which it applies there is no problem - the employee will include the contribution in his income in that year and claim his deduction in the same year. Where the Employer's contribution for a calendar year is made after the end of that year, however, we may have chaos if the IRS sticks with its position as stated in the General Instructions. It says that if the Employer makes his contribution for a calendar year within the first 3½ months of the following calendar year he must provide his employee with an additional Form W-2, reflecting the additional SEP contribution. Apparently, the IRS has made this decision in a total vacuum. It has only looked at the federal income tax aspects of this approach, and has failed to consider either the payroll or the state income tax impact. Let us discuss each of these for a moment.

Employer's Federal Payroll Taxes - An Employer is required to file a federal payroll tax return, Form 941, each calendar quarter, reflecting the compensation paid to all employees during that quarter. The return for the 4th quarter of the year is due by January 31st of the following year. If the Employer makes his SEP contribution after that date, it will apparently require his filing some type of an amended Form 941, and may necessitate his making an additional payment. It could also affect the federal and/or state unemployment tax return that the Employer is required to file; we assume that the normal penalty applicable to under-payment of these taxes would be waived. The Employer is also required to file a Form W-3 with the IRS. This Form is used to transmit all of the W-2 forms which the Employer has prepared for the year, to the IRS. The W-3 is due by the end of February of each year. Once again, if the Employer makes his contribution after the February filing date for the W-3, it will require the preparation of an amended return. Even many relatively small Employers have automated the preparation of their payroll tax returns. The IRS approach may cause some interesting problems for these people in regard to making these changes.

State & Local Income Taxes - As we have mentioned on a number of occasions, many state and local taxing authorities do not follow the federal tax laws. If an Employer makes a SEP contribution after the 1979 year-end, many state income tax laws will require the income to be reported by the employee on a cash basis, in the year in which the contribution is made (1980); while the federal requirements would include the amount on an accrual basis, in the employee's income in the year for which the contribution was made, 1979. Although the Congressional idea which initially created this monster was bad, the IRS has now topped them. I'm beginning to believe this whole thing is no more than a bad night-mare...AND...when we wake up, the whole SEP concept will have vanished, and sanity will have been restored.

II. GUIDELINES

A. Participation - The Model Forms assume that the Technical

Corrections Act of 1979 will pass and that union employees will be allowed to be excluded.

B. Contributions - You may not use a 5305-SEP to establish a Social Security Integrated SEP, although the ability to integrate the SEP is probably its most attractive feature. Those of you who have ordered and are using the NRPTC Model IRA-SEPP know how important this feature is when marketing these Plans. By eliminating this option, the IRS has made the Model Form undesirable for many Employers. Even if an Employer does not intend to integrate its SEP at this time, many will want the right to do so at a later date. With the Social Security Tax scheduled to rise in the next few years to over 7% on wages over $30,000, the availability of this option is critical. We believe we understand the IRS dilemma. Social Security integration is a concept contained in §401 of the Code. It appears that Employer's with integrated qualified plans may be able to achieve discrimination in favor of highly compensated employees by instituting an integrated SEP Plan in conjunction with their integrated Qualified Plan. Also, self-employeds who would not otherwise be able to integrate a Keogh Plan could Integrate a SEP.

The second paragraph of this section also indicates that if the Employer makes contributions, they must be made on behalf of all employees who have met the eligibility requirements; whether or not they are still employed at the time such contributions are made. This raises a few important issues.

A. #8 in the Questions and Answers section indicates that the Employer can require an employee to establish an IRA-SEP as a condition of employment. Assuming that such a provision is enforceable, we would think that the Employer would want to do this as a matter of course to insure the integrity of the program. If he failed to establish such a requirement, one dissident employee could conceivably destroy the entire program.

B. It's interesting to note that the Congressional Joint Committee on Taxation, in their written comments on RA'78 which created the SEP, indicated that an Employer could require an individual to be an employee of record on a given date in order to be eligible for an IRA contribution for a particular year. For example; under the Joint Committee comments, an Employer could require an individual to be an employee of record on a particular date; i.e. December 31. This would allow the Employer to exclude employees who are only seasonal. It now appears that such employees would have to be covered if they worked in 3 out of the preceding 5 years. Although the Form 5305-SEP doesn't actually contradict the Joint Committee statement, it doesn't have language which supports that approach either.

III. QUESTIONS AND ANSWERS:

Question 4: As previously pointed out, this deals with the doubling up concept. The price will be an administrative nightmare for both the Employer and the employee.

Example I: Selma Lowery works for Walsh's Wonderful World of Waffles, which does not have a pension plan for its employees. In December, Mr. Walsh announced that the company had adopted an IRA-SEP, fulfilling his promise to give everyone a "piece of the pie". A contribution of $700 (7% of her $10,000 compensation) was made for Selma into the IRA which she established. In January 1980, Selma filed her Federal and State Income Tax Returns. Since she lived in New Jersey, she could not take an IRA deduction for state income tax purposes. In March, Walsh made an additional SEP contribution of $500 for Selma. He supplied her with an additional W-2 form, reflecting only the $500 contribution.

Let's see what happens:

1. Selma must file an amended Federal Income Tax Return (1040-X) showing the extra $500 as 1979 income, and claiming her deduction for $500.

2. Selma may have to file an amended New Jersey Income Tax Return if the additional income is considered paid and received in 1979. This would happen if New Jersey adopted the rule set forth in Question 4; otherwise, the amount would probably be included in 1980. Her Employer's Federal W-2 won't show it. (Does this mean that the Employer will have different information on the federal and state withholding forms?)

Question #7: Once again, the IRS seems to be making a mountain out of a molehill. We do, however, agree with the IRS when they state: "A TRANSACTION OF THIS SORT COULD RESULT IN COMPLEX TAX CONSEQUENCES REQUIRING PROFESSIONAL ADVICE". A word of warning: Don't give that advice yourself!!!

Questions 8 & 10: This is a key problem with the IRA-SEP. The NRPTC Document Kit has a form for the employee to sign; indicating his consent to participate, his agreement to neither fund nor establish a spousal account; and the fact that continued participation in the IRA-SEP is a condition of employment.

Question 11: One of the virtues of the SEP is that it can be supplemental to a qualified Plan. The 5305-SEP form, however, may not be used in any case where another Plan is maintained.

Question 14: Apparently, the IRS anticipates that the Employer will give each eligible employee some form of annual statement. By the reference to question #4, we wonder whether the new Form W-2, to be used starting in 1980, will be sufficient, or whether something similar to the June 30th Statement which is required to be provided by the Trustee or Custodian by June 30th is what they have in mind. We also wonder what the Trustee or Custodian will have to provide; we would guess that it would still be the June 30th Statement.

*

We anticipate additional information being issued by the Treasury and the DOL within the next few weeks. We will keep you abreast of all further developments....

Financial Institutions
RETIREMENT PLANS
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COVERAGE THAT IS COMPREHENSIVE
YET COMPREHENSIBLE

October 1979

ARE SIMPLIFIED EMPLOYEE PLANS BETTER THAN QUALIFIED CORPORATE PLANS?

Simplified Employee Pension Plans (SEPs), which were created under the Revenue Act of 1978, are probably one of the hottest items in the pension field and the least understood. Congress, with the use of a single word, "Simplified", has probably accomplished the kind of result that some private sector firms would be willing to pay millions to an Ad Firm to achieve. While a SEP provides an employer with a new dimension for the delivery of retirement benefits for its employees, there is some question as to whether it is a realistic alternative. We have decided to take a moment to make a comparison between a SEP and a Qualified Corporate Plan (QP), to see whether the SEP really offers any special benefits. Since SEPs are generally going to be established by small employers, we will approach our discussion from the point of view of the attractiveness to the employer.

1. Who May The Employer Exclude From The Plan

SEP - Employees who have not attained age 25 and who have not performed services in at least three of the last five years. It should be noted that whereas qualified plans make reference to "years of service", SEPs do not.

QP - The eligibility provisions depend upon the vesting provisions. If the employer wants graduated vesting, he may only exclude employees under age 25 who have not completed a "year of service" (1000 hours). If he's willing to allow full and immediate vesting, he may extend the exclusion to preclude employees who have not completed at least 3 years of service. In any event, strictly seasonal employees may be excluded if they do not complete 1000 hours of service.

... ADVANTAGE - QP

IN THIS ISSUE:

. Don't Argue With The Experts
. What Roles Do Different Persons Play With Respect To Employee Plans
. Keogh Premature Distributions - IRS Continues Liberal Appraoch
. Senate Holding Hearings on TCA '79

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2. <u>What Percentage of The Employees Must Be Covered?</u>

SEP - All eligible employees must be covered.
QP - The employer may exclude up to 30% of his employees.

.... ADVANTAGE - QP

3. <u>May a Participating Employee Have His Own IRA?</u>

SEP - If he is participating in a Sep, Yes. Deductible contributions may be made by the employee to bring the combined amount of the Sep and the IRA up to 15% of his earnings, not to exceed $1500. This is only allowed, however, if the participant is otherwise eligible for an IRA. At present, this is a significant advantage over corporate plans since it allows an employee to accumulate a reasonably sufficient benefit, even if his employer's contributions are small. This advantage, which is exclusive to the Sep, will be eliminated when Congress eventually passes one of several proposals which will create a Limited Employee Retirement Account (LERA). The LERA concept, if enacted, would allow an employee to make an IRA type contribution even when he is a QP participant.

QP - If he is an "active participant" in a QP, No. He would be ineligible to make a deductible IRA contribution.

... ADVANTAGE - SEP

4. <u>How Much of An Annual Deductible Contribution May Be Made?</u>

SEP - 15% of the participant's compensation, not to exceed $7,500.

QP - The employer may deduct contributions into a profit-sharing plan of up to 15% of the total compensation paid to all participants, with no dollar limitation. §415 of the Code limits the amount that may be allocated to any participant's account in any year to the lesser of 25% of the participant's income not to exceed $32,700.

... ADVANTAGE - QP

5. <u>Is There Any Limitation On The Compensation On Which The Contribution Is Based?</u>

SEP - Yes. $100,000. In order for an employee in a SEP, who is earning $250,000, to receive the maximum $7500 contribution, all employees would have to receive at least a <u>7.5%</u> contribution. (i.e., 7.5% x $100,000 (the $ limitation) = $7500)

QP - No. An employee in a QP, earning that same $250,000, may receive a $7500 contribution while limiting employees to as little as a <u>3%</u> contribution. (i.e., 3% x $250,000 (no $ limit) = $7500)

... ADVANTAGE - QP

6. Is The Employer's Contribution Deductible For State Income Tax Purposes?

SEP - It depends on the laws of the particular state. Those states which follow the federal law will probably amend their statutes to provide for a full $7500 deduction by the employee. Other states allow only a partial deduction, while still others allow none at all.

QP - To the best of our information, there is no state which taxes an employee at the time that his corporate employer makes a contribution into it's qualified plan.

... ADVANTAGE - QP

7. May Employer Contributions Be Integrated With Social Security?

SEP - Yes. If the employer is willing to limit contributions to 6.13%, he can eliminate all contributions on behalf of participants earning less than the present Social Security wage base of $22,900. Of course, Compensation under a SEP is limited to $100,000. Since a SEP is not a qualified plan under §401, it appears to be possible to "double integrate" by using an integrated SEP in conjunction with an integrated QP. We expect that this apparently unintended advantage will be eliminated at some point in the near future.

QP - If the employer is willing to limit contributions to 7%, he may eliminate employees who earn less than the Social Security wage base ($22,900). Also, compensation is not limited to $100,000.

... ADVANTAGE - SEP
(Because of the availability of "double integration")

8. Are Employer Contributions Subject to FICA & Unemployment Taxes?

SEP - Yes. However, the Technical Corrections Act of 1979 (if passed) will correct this problem.

QP - No.

... ADVANTAGE - QP

9. Once The Employer Makes The Contribution, May The Participant Immediately Withdraw It?

SEP - Yes. If the employee has no self-control, the employer may find that he is not providing a retirement benefit. However, this feature is good for employees who have special needs; i.e. purchase of a house.

QP - Generally, no. The employer will usually restrict the availability of the funds.

... ADVANTAGE - EVEN

10. Are There Any Special Payroll Tax Considerations?

SEP - Yes. The employer is not required to withhold Federal Income Tax if he reasonably believes that the employee will be entitled to take a deduction for the SEP contribution. The state income tax withholding requirements must still be observed, however. Contributions after year-end also involve special considerations. The employer must give the employee a "special" additional W-2 Form showing only the contribution or additional contribution made after year end. This amount must then be included in the previous year's income. Although this may not complicate matters for the employee, since his FIT return need not be filed until April 15, it will probably result in a nightmare for the employer with respect to the filing of his Federal and State payroll tax returns.

QP - There are no special payroll tax considerations.

... ADVANTAGE - QP

11. When Must The Employer Make The Contribution?

SEP - The employer's deduction is based upon the calendar year. All contributions must be made by April 15th.

QP - The employer may make the contribution at any time up to the due date for filing its Federal Income Tax Return including extensions.

... ADVANTAGE - QP

12. How Are Distributions Taxed?

SEP - All distributions are taxable as ordinary income. Five year income averaging is available.

QP - Distributions which qualify as "lump-sum distributions" are eligible for 10-year averaging. All other distributions are taxable as ordinary income; 5-year income averaging is available.

... ADVANTAGE - QP

13. What Are The Rights of a Participant's Creditors?

SEP - The answer to this question depends upon whether these plans come under Title I of ERISA. At first blush it would appear that the Congressional intent was to remove these plans from Labor Department jurisdiction. If so, Federal law does not protect the assets from creditors.

QP - Corporate plans are covered under Title I of ERISA, and the assets are protected from creditors by Federal law.

... ADVANTAGE - QP (apparent)

14. Are The Distributions Subject to Any Penalties?

SEP - Since a SEP is an IRA, distributions to a participant before he attains age 59½ are subject to a 10% penalty.

QP - There is never a penalty imposed on an individual for taking a distribution from a Corporate QP.

... ADVANTAGE - QP

15. Are The Funds Available To Participants At age 59½?

SEP - Yes. Once a Participant attains age 59½, the funds in the account may be withdrawn at will. This unique treatment appears only in this section (IRA) of the law. It affords the individual unlimited discretion in determining the amount to be included in each year's income. Only the amount actually withdrawn in any year will be included in income. No structured distribution is required to be established.

QP - Distributions are only available pursuant to the benefit provisions under the plan. Generally, this requires the participant to leave the company.

... ADVANTAGE- SEP

16. Must Distribution Begin At Age 70½?

SEP - Yes.

QP - No. Corporate QP plans represent an important estate tax shelter.

... ADVANTAGE - QP

17. What Are The Reporting Requirements?

SEP - Although intended to be simplified, they have yet to be stated. If the employer uses the IRS Form 5305-SEP, he will have satisfied most of his requirements.

QP - The reporting and disclosure requirements include:

a) Summary Plan Description
b) Summary Annual Report
c) Notice To Interested Parties
d) 5500-C

... ADVANTAGE - SEP
(Probably)

****

Senator BYRD. Thank you, Mr. Newman.

Does Treasury have a comment?

Mr. FERGUSON. Mr. Chairman, the intent of the 1978 legislation in creating the simplified employee pensions was to keep that mechanism simple. I have some reservations about changes that would provide elections and waivers and might complicate the system. Mr. Newman's statement is certainly something we will take a look at with that simplification objective in mind and also, of course, with the objective of drawing a line between technical and substantive changes. With those two guidelines, we would like to review the statement and see whether possible modifications or additions to H.R. 2797 would seem to be in order.

Senator BYRD. The next witnesses are a panel consisting of Mr. Richard Storm and Mr. Gene Howard of the American Fishing Tackle Manufacturers Association.

Senator Boren.

Senator BOREN [presiding]. I appreciate very much Chairman Byrd's inclusion of S. 1549 on today's agenda. This bill, which I introduced, has been cosponsored by Senators Bellmon and Percy and four other members of the Finance Committee, Senators Nelson, Danforth, Durenberger, and Chafee. It is of vital concern to manufacturers of fishing tackle, 97 percent of which are small businesses.

Under current law, fishing tackle manufacturers pay a 10 percent excise tax on products which are shipped approximately 4½ months before they receive payment for the items. Since over 85 percent of all shipments occur within three quarters, manufacturers are forced to finance the tax for a considerable length of time. This creates an external market force affecting employment, inflation, and stable production throughout the year. A substantial financial hardship has resulted for the nearly 400 fishing tackle manufacturers who pay the tax.

S. 1549 would defer the payment of this excise tax for one quarter in each of the first three quarters of the Federal fiscal year with final quarter payments due at such time as the Treasury Secretary prescribes. The legislation would greatly reduce the hardships being experienced by this industry and would have no negative impact on the revenue which is earmarked for the Dingell-Johnson fish restoration program.

We are very pleased today to have two distinguished witnesses from my home State, Richard Storm, vice president of Storm Manufacturing Co. of Norman, and Gene Howard, vice president of the Zebco Division of Brunswick Corp., also from Tulsa. This is an industry that we are very proud of. It started out small and continued to grow and represents what can happen in our free economic system in this country.

I understand both of you are representing the American Fishing Tackle Manufacturers Association.

We are glad to have you here. Which one of you would like to go first?

STATEMENT OF RICHARD STORM, VICE PRESIDENT, STORM MANUFACTURING CO.

Mr. STORM. Mr. Chairman, I am Richard P. Storm from Norman, Okla. I represent the American Fishing Tackle Manufacturers Association, as well as my family-owned small fishing tackle business.

I have here a statement of the AFTMA's position on this bill which has unanimously passed the House in the form of H.R. 5505 and which I would like to have entered into the record.

Senator BOREN. So ordered.

Mr. STORM. Our particular business started in my brother's back garage and it has now grown to employ some 80 or 90 people through 15 years of unremitting hard work. Our lures are sold throughout the United States and are exported to Japan, Canada, and other countries.

I would like to emphasize the seasonal nature of the fishing tackle business. The sales in this business primarily occur in the fourth quarter of one year and in the first and second calendar quarters of the following year. The sales during the third quarter are small. These sales occur on credit terms of as much as 180 days and these terms are dictated by the intense competition among the various members of the fishing tackle industry.

Therefore, payments which are received in April, May, and June of a year are for sales and shipments which have occurred in October, November, and December of the preceding year. Therefore, the excise tax which under current law is due 9 days after the close of the semimonthly liability period—for smaller companies it is 31 days after the close of the liability period—occurs considerably before the possibility of collection of any of the money for these lures from the customers. This creates a very serious financial hardship in that our company has to borrow money at a currently high rate of interest to pay this tax, when I would rather use that money to hire more people to produce more lures during that period late in the year in order to timely make shipments of the goods.

The net effect of this bill is not to change the tax or its amount but simply to defer the payment to a time which does not cause economic hardship to the small businesses which are primarily paying this tax.

I would also like to make an input on the financial impact of the excise tax on new individuals getting into the lure business in that they find it very difficult to do so because their limited funds which they usually would put into manufacturing lures and the expenses of selling them, go to pay the tax on these lures considerably before they have any opportunity to get any recompense for their sales.

Another thing which I would like to emphasize is the reduction in paperwork which would be involved; the paperwork would be reduced from six times per quarter to once per quarter, saving some 500 percent.

I would like to express my appreciation for the opportunity to present these arguments before the committee.

Senator BOREN. Thank you very much. We appreciate the comments that you have made.

Do you have any idea in talking about the fact that the increasing interest rate makes it more difficult in terms of the cost now to go out and borrow the money to pay the excise tax?

Mr. STORM. That is right.

Senator BOREN. In a business of your size what volume of money are we talking about in terms of gross sales?

Mr. STORM. My company has gross sales during the year of about $1.5 million.

Senator BOREN. So you are talking about $150,000 going into the tax.

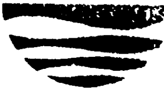
Mr. STORM. That would be a typical tax liability. We are able to pay some of that tax from accumulated earnings which we use in the operation of the business but typically we have to go to the bank and borrow money in either November or December of each year and use that money to operate on as well as to pay the tax liabilities for that period. I would rather use the money that is spent for tax collection to timely manufacture more lures, because we could certainly use all the inventory that we can produce to ship orders.

Senator BOREN. The House of Representatives have already acted favorably on a similar piece of legislation.

Mr. STORM. Yes. I believe this was House bill 2459 which unanimously passed the House Ways and Means Committee and then was acted upon last week as a part of a package under H.R. 5505 and was passed, I believe, virtually unanimously by the entire House.

Senator BOREN. Thank you very much.

[The prepared statement of Mr. Storm follows. Oral testimony continues on p. 265.]


AMERICAN FISHING TACKLE MANUFACTURERS ASSOCIATION

Statement of

The American Fishing Tackle Manufacturers Association
2625 Clearbrook Drive
Arlington Heights, Illinois 60005

Subcommittee on Taxation and Debt Management

Senate Finance Committee

in Support of

S. 1549

November 7, 1979

AFTMA CENTER • 2625 clearbrook drive • arlington heights • illinois 60005 • 312/364-4666

Mr. Chairman: The American Fishing Tackle Manufacturers Association (AFTMA) is a national trade association headquartered in Arlington Heights, Illinois representing 400 manufacturers of fishing tackle and related equipment or about 95 percent of the industry. Of AFTMA's total membership, 97 percent are small businesses.

The basic objective of AFTMA is to educate, guide and assist the members of the Association in matters of common interest so that the members shall maintain a high standard of conduct, efficiency, and usefulness to the industry, to the government, and to the public.

The Association is the instrument by which business competitors cooperate to solve common problems, to launch and carry out industry-wide endeavors, to put individual knowledge and experience to work for all.

For 26 years, the fishing tackle industry has totally supported the concept of paying an excise tax on their equipment which, in turn, is earmarked for the Federal Aid in Fish Restoration Program, commonly known as the Dingell-Johnson or D-J Fund. This fund is one of the most substantial trusts available for conservation and fish restoration, with almot 279 million dollars having been made available to the states as of fiscal 1979. The industry advocated the self-imposed excise tax legislation in 1952, further re-endorsed its support in 1964 and our position has not changed.

Before going any further, it should be explained that the Dingell-Johnson Program was the culmination of many years of effort by conservationists and enlightened sportsmen and fishing

tackle manufacturers who saw a need to bolster the efforts of State fish and wildlife agencies in managing recreational fisheries. Congressman John Dingell of Michigan and Senator Edwin Johnson of Colorado introduced the legislation which provided that the ten percent manufacturer's excise tax on fishing rods, reels, creels, and artificial lures, baits, and flies be made available to states and territories for management projects and sport fishing recreation. In conjunction, the States must assure that their fishing license revenues are dedicated for only the administration of state fish and wildlife agencies.

The excise tax, collected by the manufacturer or importer are paid to the Treasury Department, is appropriated to the U.S. Fish and Wildlife Service annually for apportionment among the states and territories. Each state's share is based 60 percent on the number of licensed sport fishermen and 40 percent on the land and water area of the state. No state may receive more than five percent nor less than one percent of the total.

The cost of each D-J project is supported with 25 percent state funds and 75 percent Federal funds with most of the state money derived from sport fishing license revenues.

The Federal Aid in Fish Restoration Program has made more than 279 million dollars available to date, allowing state fish and wildlife agencies to construct 264 new lakes, totaling 21,768 surface acreage; public access to 777,334 acres of lakes and habitats; protection of fish from pollution, highway construction, water diversions, logging, and poor farming practices; and development of research and new management techniques.

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Thus, because of the Dingell-Johnson program, most of America's 64 million sport fishermen benefit from the wide-range of projects aimed at helping our nation's fisheries.

Attached to this statement is a chart which illustrates, by state, the apportionment of the D-J fund since the program first began. As members of the Senate review this material and study S. 1549, the fact should be understood that the health of the industry is paramount to sustaining a strong Dingell-Johnson program for every state. S. 1549 will not negatively affect the level of revenue for the D-J fund and seeks only to defer the payment of excise tax by manufacturers for the first three quarters of the government's fiscal year.

The major problems confronting the fishing tackle industry are primarily as a result of the time schedule that is now required by Section 4161(a) of the Internal Revenue Code of 1954 for the payment of the ten percent tax on the value of applicable fishing tackle items. AFTMA and its member manufacturers do not challenge the percentage level of taxation, nor the amount of money that is ultimately collected from manufacturers throughout the year.

Under the current law, if the liability for excise tax reported exceeds $2,000 for any month in the preceeding calendar quarter, the manufacturer must deposit his excise tax on a semi-monthly basis within nine days after the close of the period involved. Consequently, the manufacturer is required to deposit his excise tax at a time closely coinciding with the date of shipment. This is when the problem begins for small fishing tackle businesses. Currently, fishing tackle manufacturers do

not receive payment for their products on the average of 5.3 months after the time of shipment.

The lag time between the shipping date and the time when payment is received from the vendee is a direct result of the fact that the fishing tackle industry has had to adhere to a highly seasonable, but predictable production cycle that basically begins with product development during the late spring and summer months; order taking during the latter part of the summer; and heavy shipments starting in October and continuing through March. In order to induce distributors and retailers to purchase the manufacturer's goods during periods of the year when they are not being heavily sold directly to the sport fisherman, it has been necessary for every member of the industry to grant dating terms to vendees to maintain steady employment and production. The granting of terms is dictated by the industry's customers and not the industry. This situation did not exist 26 years ago when the D-J fund was created. New problems have developed since 1952 which mandate that the industry seek relief from the contemporary problems of this increasingly serious dilemma of paying an excise tax well in advance of getting paid for the products taxed.

The overall consequence of this entire situation has been the every-increasing need for small to medium sized businesses particularly to obtain expensive short-term financing in a highly competitive money market for a tax that should not have to be paid until the manufacturer receives his payment within a reasonable time period.

Other industries still covered by excise taxes such as gasoline, truck parts, inner tubes and tires, lubricating oil,

etc., cannot demonstrate the seasonal shipping variations that exist for fishing tackle manufacturers. Worse yet, as opposed to other industries subject to excise tax, 97 percent of the tackle manufacturers are small businesses wherein cash flow is proportionately a much more intense problem, affecting every aspect of their operations.

Over the past six years, for example, an average of 64 percent of all AFTMA member shipments has occurred in the second and third fiscal quarters of the current government fiscal year. Under the present law, a concentration of shipments also means a concentration of excise tax payments at a time when cash flow is crucial because of dating terms. This situation is particularly illustrated by the level of shipping that occurs in the second quarter. Consequently, most of the small fishing tackle businesses are forced to use short-term financing in a highly competitive market to pay the excise tax. The current excise tax payment schedule is causing substantial cash flow hardships affecting absolutely every other phase of the fishing tackle manufacturer's operation, from the purchase of components to employment. These financial problems are further compounded by an industry growth of 321.6 percent that has added to their total excise tax liability, necessitating a growing requirement to borrow larger amounts of money to pay excise tax.

It is the industry's strong belief that the payment of excise taxes on fishing tackle, which are earmarked for specific projects, should be scheduled in such a way as to effect the least possible distortion in the economic forces governing the production of the items taxed.

Like many other types of businesses across the U.S., fishing tackle companies must also meet their obligations for various production costs and business taxes which are traditionally related to the manufacturing and sale of a product. But, the application of the ten percent excise tax on fishing tackle shipments, that are ear-marked solely for the Dingell-Johnson fund and furthermore, a fund which only the fishing tackle industry pays for, is a special tax in general comparison to vendors of other products. In AFTMA's opinion, the schedule for payment of excise tax can be adjusted to reasonably meet the specific cash flow and operational needs of the industry without endangering the well-being of the trust fund which, as noted earlier, is totally supported by all manufacturers.

AFTMA and the fishing tackle manufacturers whose products are covered by the excise tax seek to amend Section 4161(a) of the Internal Revenue Code of 1954 in regard to the imposition of the ten percent excise tax.

The proposed bill seeks to defer the payment of excise tax by the manufacturer for a minimum of 90 days, but no more than 180 days. That is, the manufacturer would be required to pay the full amount of excise tax due at the end of the quarter immediately following the quarter in which shipment was made to the vendee. The only exception would be for fourth quarter shipments for which the excise tax will be paid as usual in order to avoid any revenue or budgetary affects on the D-J program. The manufacturer is still totally responsible for the collection and deposit of excise tax, regardless of the status of his receivables at the time when the tax is due under the proposed schedule for payments in S.1549.

The excise tax on fishing tackle products is earmarked for the Dingell-Johnson Trust Fund, and this legislation would not result in any budgetary effects when implemented.

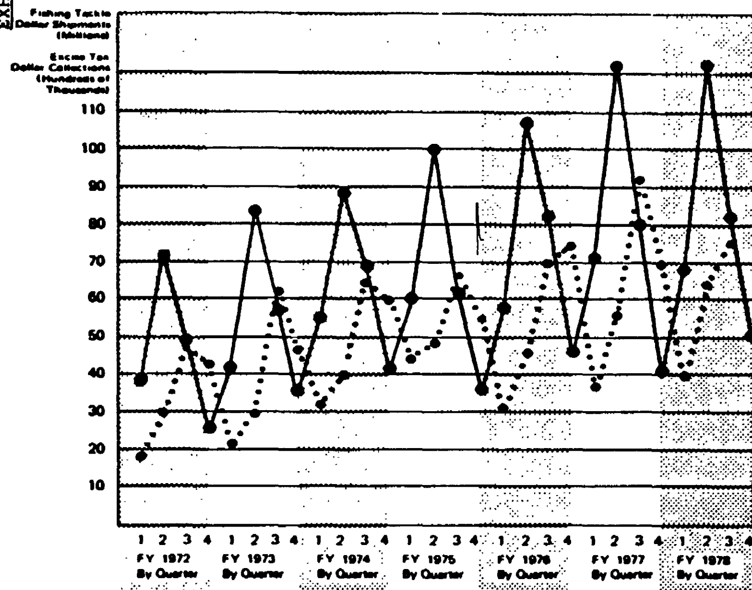
It is AFTMA's strong belief that excise taxes, which are earmarked for specific trust activities, should be imposed in such a way to effect the least possible distortion in the economic forces governing the production of the items taxed. The proposed bill does not endanger, in any way, the Federal Aid in Fish Restoration program and provides a much needed stimulus for fishing tackle manufacturers to further expand their production, stabilize employment and reduce the inflationary pressure which has resulted from the current requirement to pay excise tax on products shipped well before the payment has been received.

S. 1549 is an equitable compromise between maintaining a strong Federal program for conservation and fish restoration and at the same time providing much needed relief for small manufacturers thereby enabling them to further expand their production, stabilize their employment throughout the year and reduce the unnecessary financial pressure which has resulted from the requirement to pay excise tax on shipments well before the payment has been received.

Positive action by the 96th Congress to reduce the hardship resulting from premature payment of excise taxes can and will have a dramatic effect on an entire industry, a majority of whom are small businesses.

The proposed legislation is highly important to the seasonal fishing tackle industry. AFTMA and its members urge that a favorable consideration be given to S. 1549.

AFTMA wishes to thank the members of the Subcommittee for this opportunity to present our views and background information in support of S. 1549



SOURCES: • American Fishing Tackle Manufacturers Association Monthly Market Trend Reports
• Internal Revenue Service News Releases

Fishing Tackle Shipments (Excise Tax included)

Excise Tax Collections

FISHING TACKLE SHIPMENTS (000,000)

Fiscal Year	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	Total
1972	38.5	71.3	48.7	25.2	183.7
1973	41.7	83.6	57.3	35.5	218.0
1974	56.5	88.6	69.3	41.7	256.1
1975	59.7	100.0	61.1	36.1	256.9
1976	57.8	107.7	82.3	45.8	293.6
1977	71.0	121.0	79.9	40.5	312.4
1978	68.0	121.5	81.5	50.8	321.8

EXCISE TAX COLLECTIONS (00,000)

Fiscal Year	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	Total
1972	18.4	30.0	47.6	42.8	138.8
1973	21.6	29.5	61.5	46.2	158.8
1974	31.9	39.8	64.7	59.8	196.2
1975	44.3	48.2	66.7	54.9	214.1
1976	30.9	45.8	69.9	74.3	220.9
1977	36.8	56.1	91.9	69.4	254.2
1978	39.4	63.7	74.9	N/A	N/A

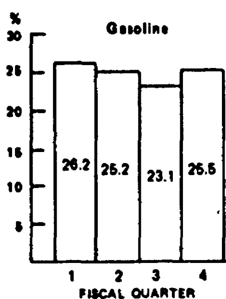
N/A — Not Available

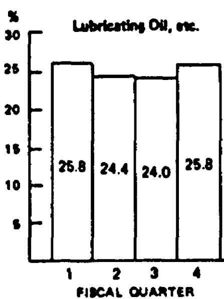
Prepared for AFTMA by Ernst & Ernst
Chicago, Illinois

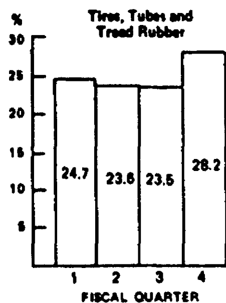
EXHIBIT II

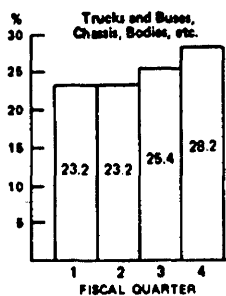
QUARTERLY MANUFACTURERS EXCISE TAX COLLECTIONS AS A PERCENT OF ANNUAL COLLECTIONS

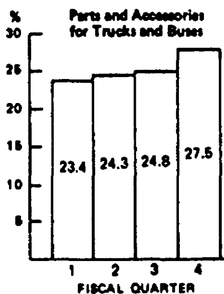
Average For Fiscal Years Ended September 30, 1974 - 1977

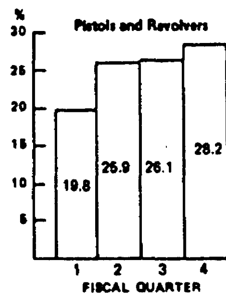


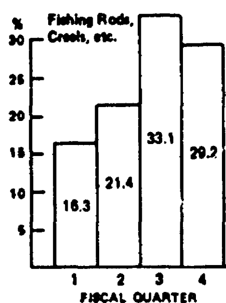


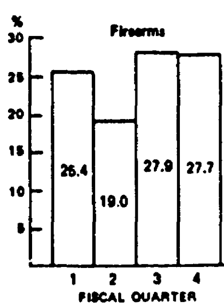












SOURCE: Internal Revenue Service News Releases

Prepared for AFTMA by Ernst & Ernst
Chicago, Illinois

CHART III

Fishing Tackle Shipments*
Dollar Value at Manufacturer's Level
(Excise Tax Included)
1952-1978

Year	Value
1952	$ 68,548,000
1953	76,944,000
1954	72,684,000
1955	75,566,000
1956	73,561,000
1957	79,200,000
1958	76,067,000
1959	79,075,000
1960	74,062,000
1961	76,192,000
1962	77,822,000
1963	84,087,000
1964	85,967,000
1965	101,381,000
1966	109,652,000
1967	125,317,000
1968	141,572,000
1969	155,656,000
1970	171,606,000
1971	168,296,000
1972	180,688,000
1973	214,566,000
1974	250,915,000
1975	252,677,000
1976	266,951,000
1977	277,122,000
1978	288,040,000

*The dollar values of manufacturer's shipments that are shown reflect approximately 70 percent of the total industry volume based on statistices reported by AFTMA members.

Public fishing lakes from which the man-days of fishing per acre have been provided.

Region	No of States	No of Lakes	Surface Acres	No. of Man-days	Man-days Per Acre
Western States	3	[illegible]	237	8,700	36.70
Southwestern States	3	31	20,496	539,028	26.50
North Central States	3	23	4,000	416,976	104.24
Southeastern States	5	12	2,134	291,619	136.65
Midwest States	6	67	6,502	1,125,256	173.06
Total	18	134	33,369	2,381,579	71.37

Trends in Apportionments to States and Territories

State	1952-73	1974	1975	1976	Total
Alabama	$ 2,570,594	$ 256,310	$ 292,681	$ 353,935	$ 3,473,520
Alaska	6,473,955	731,500	842,500	1,010,000	9,057,955
Arizona	2,896,695	297,074	337,889	417,394	3,949,052
Arkansas	2,855,775	293,362	328,321	413,458	3,890,916
California	7,498,533	731,500	842,500	1,010,000	10,082,533
Colorado	3,525,513	358,146	396,677	498,707	4,779,043
Connecticut	1,499,706	146,300	168,500	202,000	2,016,506
Delaware	1,499,706	146,300	168,500	202,000	2,016,506
Florida	3,229,574	359,602	419,202	506,903	4,515,281
Georgia	3,095,730	292,719	336,136	403,800	4,128,385
Hawaii	1,414,111	146,300	168,500	202,000	1,930,911
Idaho	2,533,230	255,813	302,573	358,489	3,449,105
Illinois	4,094,486	352,748	405,469	448,930	5,301,633
Indiana	3,444,212	281,339	302,507	365,391	4,393,459
Iowa	2,622,350	239,412	265,823	321,498	3,449,083
Kansas	2,563,056	248,640	280,247	329,459	3,421,402
Kentucky	2,336,063	231,014	260,822	317,960	3,145,859
Louisiana	1,864,235	192,416	222,404	289,991	2,569,046
Maine	1,534,036	146,300	168,500	202,000	2,050,836
Maryland	1,499,706	146,300	168,500	202,000	2,016,506
Massachusetts	1,499,706	146,300	168,500	202,000	2,016,506
Michigan	5,824,328	518,026	560,661	674,194	7,577,215
Minnesota	6,827,321	597,900	677,148	742,307	8,844,676
Mississippi	1,978,454	196,807	215,397	286,107	2,676,765
Missouri	4,002,524	385,579	446,889	524,600	5,359,592
Montana	3,465,679	323,718	378,945	447,405	4,615,747
Nebraska	2,212,882	200,361	231,041	271,281	2,915,565
Nevada	2,232,465	223,370	260,377	317,538	3,033,750
New Hampshire	1,499,706	146,300	168,500	202,000	2,016,506
New Jersey	1,499,707	146,300	168,500	202,000	2,016,507
New Mexico	2,641,050	250,594	291,984	354,923	3,538,551
New York	4,109,515	327,684	401,393	482,085	5,320,677
North Carolina	2,499,569	229,903	273,950	332,926	3,336,348
North Dakota	1,567,781	156,395	182,028	222,493	2,128,697
Ohio	4,159,345	310,024	362,780	468,672	5,300,821
Oklahoma	3,143,898	291,688	331,722	416,895	4,184,203
Oregon	3,574,063	365,175	432,442	495,500	4,867,180
Pennsylvania	3,420,905	334,090	394,775	489,697	4,639,467
Rhode Island	1,499,707	146,300	168,500	202,000	2,016,507
South Carolina	1,804,785	161,664	188,301	229,621	2,384,371
South Dakota	1,987,715	182,923	208,527	250,013	2,629,178
Tennessee	3,724,634	338,109	392,975	448,708	4,903,926
Texas	7,331,493	731,500	842,500	1,010,000	9,915,493

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Exhibit IV 37

State	1952-73	1974	1975	1976	Total
Utah	2,348,029	245,739	299,546	365,028	3,258,342
Vermont	1,499,707	146,300	168,500	202,000	2,016,507
Virginia	2,259,291	217,853	257,567	311,835	3,046,546
Washington	2,977,060	260,471	311,992	367,873	3,917,396
West Virginia	1,514,500	146,300	168,500	202,000	2,031,300
Wisconsin	5,661,074	532,316	614,699	705,952	7,514,041
Wyoming	2,361,593	231,605	266,803	312,433	3,172,434
Guam	225,117	48,767	56,167	67,333	397,384
Puerto Rico	7,445,350	146,300	168,500	202,000	7,962,150
Virgin Islands	285,117	48,767	56,167	67,333	457,384
American Samoa	85,117	48,767	56,167	67,333	257,384
Total	$151,220,653	$14,630,000	$16,850,000	$20,200,000	$202,900,653

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Senator BOREN. Mr. Howard, we would be happy to hear from you now.

STATEMENT OF GENE HOWARD, VICE PRESIDENT, ZEBCO, A BRUNSWICK CO.

Mr. HOWARD. Thank you, Mr. Chairman.

I would like to have a copy of my prepared statement entered into the record.

Senator BOREN. The full statement will be entered in the record.

Mr. HOWARD. My name is Gene Howard and I am vice president of Zebco, a fishing tackle company, as you have already mentioned, Senator, located in Tulsa, Okla. Zebco is one of the companies which initially supported the imposition of an excise on our products in 1952 and has never changed its position. The company recognized then that a development program to promote or support the fishing industry was necessary in order to attract the new and retain the old participants, giving them a reasonable chance of being successful when they go fishing.

As you know, the funds over the years have been used for more surface acres, more access to facilities. It is important, I think, to point out that all of these things were supported or funded from the sale of our own products and taxed on our own initiative. I think it is extremely important to bring out the record that this is a self-imposed tax for the purpose of fish restoration.

One of the ways to increase the availability of the Dingell-Johnson funds is for manufacturers to increase our sales. Historically the fishing tackle year begins on August 1 with new products, prices, and programs and ends the following July 31. When the tax was initially imposed back in 1952, about 20 percent of Zebco's annual sales were generated during the period from August through December and we designed some marketing tactics to get the products on the customers' shelves ahead of the normal selling season which is January through May and it resulted in the practice of offering an extended period of time for payment if the customer would accept delivery ahead of the normal receiving period. This is known in the industry as dating or terms. This marketing tactic met with enough success so that 8 years later, by 1960, 30 percent of our annual sales were from August through December.

It was about this period of time that the Japanese began to make some inroads in the U.S. market. In 1961, to block the cheap imports, Zebco introduced an inexpensive reel named the Model 202 and used this reel in a free goods program that required orders to be shipped by November 30 in order to qualify for maximum discounts as well as dating programs. By 1965, over 35 percent of sales were generated in the August through December period, increasing to over 40 percent in recent years and sold under some form of dating.

All this to say that over the years since the excise tax legislation was enacted, the calendarization of sales has changed as a result of programs and promotion which, in turn, has resulted in increased sales. Our experience has been that if the products can be placed in the hands of the customer, he will find a way to move them ahead of the normal selling season also.

In 1978, over 50 percent of the industry sales were to wholesalers or jobbers who, in turn, must offer dating to his retail customers. This type of outlet historically has been undercapitalized and must receive his money before he can pay us. This is an additional reason why dating is so prevalent in the industry.

While the primary motive in offering dating is to increase sales and related profits, an important benefit is the leveling of production to make maximum usage of the physical facilities. The same annual volume can be obtained from less investment in property, plant, and equipment if production is relatively even from month to month rather than running at an accelerated pace for a few months of the year.

The same benefit to property, plant, and equipment from leveling of production is also related to the financial costs of building inventory ahead to meet peak shipping periods and trust that the demand will still be there at the seasonal peak. However, the greatest benefit of more level production is to our production workers. A stabilized work force is not only more profitable to the company but is equally more desirable from our workers' standpoint.

To sort of sum up, due to the fact that the method of selling and collecting our receivables in the industry has changed since we voluntarily imposed an excise tax on our products but the timing for remitting the tax has even increased, we feel that S. 1549 should be passed. The provisions of this bill would enable the manufacturer to more closely match the payment of the tax with the collection for the sale which was our intent in 1952.

Thank you.

Senator BOREN. Thank you very much.

When the fish restoration program was first adopted, what percentage gain did you say of your sales were linked to dating in terms of——

Mr. HOWARD. Just a little under 20 percent.

Senator BOREN. And now it is over 50 percent.

Mr. HOWARD. Over 40 and closer to 50.

Senator BOREN. So we see a very significant difference in the economic situation.

Mr. HOWARD. Our company is fairly representative of the industry because we all have about the same type of marketing programs.

Senator BOREN. How many employees do you have at Zebco?

Mr. HOWARD. Almost 1,000.

Senator BOREN. Almost 1,000. Now you are able to stabilize this work force pretty much throughout the year.

Mr. HOWARD. We would rather run at a level of production and even incur the higher inventory levels in order to stabilize. That has been in our experience the most profitable way to produce fishing lures.

Senator BOREN. It is your position to favor a continuation of the fund.

Mr. HOWARD. Certainly.

Senator BOREN. You are in no way objecting to that. The bill would in no way reduce the money going into the fund, only the timing.

Mr. HOWARD. On a fiscal year basis there is no effect on revenue.
Senator BOREN. Thank you very much.
[The prepared statement of Mr. Howard follows:]

PREPARED STATEMENT OF GENE HOWARD, VICE PRESIDENT, ZEBCO, A BRUNSWICK COMPANY, TULSA, OKLA.

Mr. Chairman, my name is Gene Howard and I am Vice President of Zebco, a fishing tackle company located in Tulsa, Oklahoma.

Zebco is one of the companies which initially supported the imposition of an excise tax on our products in 1952 and has never changed its position. The company recognized then that a development program to promote the sportfishing industry was necessary. In order to attract the new and retain the old participants, a reasonable chance of catching fish is increased if there are more lakes and, most important, more fish in those lakes. With the rapid increase in population growth over the past 25 years its is even more important today that the restoration programs funded from the sale of our own products and taxed on our own initiative be maintained and increased.

One of the ways to increase the availability of Dingell-Johnson funds is for manufacturers to increase their sales. Historically, the fishing tackle year begins on August 1, with new products, prices and programs and ends on the following July 31. In 1952, when the legislation and related timing of payments was enacted, Zebco generated about 20 percent of its annual volume from August 1 thru December 31. Marketing tactics designed to get the products on customer's shelves ahead of the normal selling season (January-May) resulted in the practice of offering an extended period of time for payment if the customer would accept delivery ahead of the normal receiving period. Known in the industry as "dating" or "terms", this tactics met with enough success so that by 1960 about 30 percent of Zebco's sales were from August thru December.

It was about this period of time that the Japanese began to make some inroads in the United States market. In 1961, to block the cheap imports, Zebco introduced an inexpensive reel named the Model 202 and used this reel in a free goods program that required orders to be shipped by November 30 in order to qualify for maximum discounts as well as dating. By 1965, over 35 percent of sales were generated in the August thru December period, increasing to over 40 percent in recent years and sold under some form of dating.

All this to say that over the years since the excise tax legislation was enacted, the calendarization of sales has changed as a result of programs and promotion which, in turn, has resulted in increased sales. Our experience has been that if the products can be placed in the hands of the customer, he will find a way to move them ahead of the normal selling season also.

In 1978, over 50 percent of the industry sales were to wholesalers or jobbers who, in turn, must offer dating to his retail customers. This type of outlet historically has been undercapitalized and must receive his money before he can pay us. This is an additional reason why dating is so prevalent in the industry.

While the primary motive in offering dating is to increase sales and related profits, an important benefit is the leveling of production to make maximum usage of the physical facilities. The same annual volume can be obtained from less investment in property, plant and equipment if production is relatively even from month-to-month rather than running at an accelerated pace for a few months of the year.

The same benefit to property, plant and equipment from leveling of production is also related to the financial costs of building inventory ahead to meet peak shipping periods and trust that the demand will still be there at the seasonal peak. However, the greatest benefit of more level production is to our production workers. A stabilized work force is not only more profitable to the company but is equally more desirable from our workers standpoint.

Due to the fact that the method of selling and collecting our receivables in the industry has changed since we voluntarily imposed an excise tax on our products but the timing for remitting the tax has even increased, we feel that S. 1549 should be passed. The provisions of this bill would enable the manufacturer to more closely match the payment of the tax with the collection for the sale which was our intent in 1952.

Senator BOREN. Does Treasury have any comments that you would like to make with regard to this?
Mr. FERGUSON. Thank you, Senator Boren.

We have stated our opposition to the bill, as you know, on the grounds that conforming the tax rules to the particular business practice of an industry does not seem to us to be desirable. One change that was made from the original proposal—a change included in your bill—minimizes the revenue impact, as I believe you mentioned or perhaps one of the witnesses mentioned.

In terms of the budget itself, there is no revenue loss. However, the interest payments that are saved by the manufacturers are borne by the Government, so there is an interest cost of roughly $1¼ million a year. It is not a cost-free measure from the Treasury point of view.

The argument that fishing tackle manufacturers have in a sense, imposed this tax upon themselves does present them in a little different light from other manufacturers. But in spite of this mitigating factor, we do oppose the bill.

Thank you for giving us a chance to explain the reasons.

Senator BOREN. I appreciate your comments. As you might imagine, I don't fully agree with them. I think that in the long run with encouragement that this legislation would provide for the continued growth of our domestic fishing tackle industry. I think the impact on the fund or on the Treasury ultimately may be a positive one because of passage of this legislation and that certainly we needed to do everything that we can to increase the efficient use of planned productivity in this country.

I do think the witnesses have made a good case for why we should perhaps depart from our usual policy of not trying to fit the tax law in every case to the situation. I think that we do have a unique industry where there are unique practices here. Also, as you pointed out, we are not dealing with something that within the fiscal year will change revenues or dedicated funds. We are also dealing with people who have supported the imposition of this tax for this purpose upon themselves.

I do appreciate your comments although with all due respect I have to differ with them in certain detail.

We appreciate the testimony of both witnesses and appreciate your taking time to appear and present the committee with this information. I know that all the members of the committee will have an opportunity to review the transcript and to have the benefit of this information before the decision is reached on this piece of legislation.

Thank you very much.

Mr. STORM. Thank you.

Mr. HOWARD. Thank you.

Senator BOREN. We have completed the scheduled witnesses for today. There being no other witnesses to appear, the subcommittee will stand in recess.

[Whereupon, at 4:43 p.m., the subcommittee recessed.]

[By direction of the chairman the following communications were made a part of the hearing record:]

TESTIMONY OF SENATOR ABE RIBICOFF ON S. 873

Mr. Chairman, I appreciate the opportunity to testify today in support of S. 873. This legislation would insure fair tax treatment for Americans working overseas who are forced to return to the United States by circumstances beyond their control in the country in which they are working. Senator Bentsen has worked closely with

me in developing this legislation. I am pleased that he and Senators Tower, Hayakawa, Church and Javits are cosponsors of this legislation.

At the present time, Americans living and working abroad are eligible to use section 911 or 913 of the Internal Revenue Code. These provisions are intended to offset excess living costs and to provide a modest incentive for Americans to work in hardship cases. In order for a person to qualify to use section 911 or 913, that person must be a bona fide resident of a foreign country or must be present in a foreign country for at least 17 out of 18 months.

It has come to my attention as a result of the recent occurrences in Iran that the above requirement can cause severe injustices in certain situations. For example, a constitutent of mine worked in Iran for 14 months and then was forced to return to the United Statess because of the revolution in Iran. That individual would have stayed in Iran for the required 17 of 18 months but for the disturbances in Iran. As a result of only being there for 14 months, he is prohibited from using the exclusion or itemized deductions provided by sections 911 and 913. This is the case even though he was in Iran for the entire 1978 calendar year. He incurred a full year of extraordinarily high housing and living costs but cannot take advantage of the provisions Congress provided so that inflated taxes would not be paid on excess living costs.

S. 873 corrects this situation by permiting the Secretary of the Treasury to waive the 17 out of 18 month requirement in certain specified situations. The Secretary could grant such a waiver when, after consultation with the Secretary of State, he determines that individuals were required to leave a foreign country because of war, civil unrest, or similar adverse conditions in the foreign country which precluded the normal conduct of business by the Americans required to leave.

The Secretary's waiver decision would be made with respect to a particular situation in a foreign country. The determination would not be made based on the situation of individual employees or particular companies. The American worker must have been required to return to the United States because of conditions in the foreign country which made it imposible for Americans to continue normal business operations.

If a waiver were granted in a specific situation, the American worker could deduct expenses deductible under section 913 attributable to the period that the individual was living and working in that foreign country. If an individual is eligible for a flat exclusion (under section 911), that individual would be entitled to the exclusion prorated for the portion of the calendar year spent in the foreign country.

This legislation would be applicable to taxpayers who are required to leave a foreign country after September 1, 1978. Thus, if the Secretary granted a waiver with respect to Iran—and it is contemplated that he would grant such a waiver—this legislation would apply to those Americans who lived and worked in Iran but were forced to leave because of the recent revolution in that country.

There is no requirement in the legislation that the waiver decision be made by the Secretary of Treasury prior to the American employee leaving the foreign country in question. There will be occasions when U.S. citizens will have to decide on their own that a place is unsafe or that it is not possible to continue normal business operations because of disturbances in a country. For foreign policy or other reasons, the decision by the Secretary might be delayed. As long as a waiver is eventually granted by the Secretary and the Secretary is satisfied that the taxpayer left because of the conditions in the foreign country necessitating the waiver, the taxpayer could take advantage of the provisions of sections 911 and 913.

Mr. Chairman, this straight forward legislation corrects a technical problem with sections 911 and 913. These provisions failed to take account of situations where a U.S. taxpayer, before having lived and worked in a foreign country for 17 out of 18 months, is forced to leave that country due to conditions in that country beyond the taxpayer's control. I urge the prompt enactment of this legislation.

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C., November 21, 1979.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: I would like to request that you include this letter as a portion of the hearing record of November 7 on the Technical Corrections Act.

I would like to bring to the Committee's attention the need for a technical correction to the Energy Tax Act of 1978 regarding Section 4221(e)(6) of the Internal Revenue Code which allows an exemption from the manufacturer's excise tax on bus parts at the point of sale to the purchaser for use on or in connection with an automobile bus. Currently, as interpreted, where one or two distributors are interposed between the manufacturer of the bus parts and the bus operator, a credit and refund procedure is required.

It would be more consistent with the legislative intent and with efficient tax administration if the procedure contained in Section 4063(e) for light duty truck parts was applied to bus parts as well. This would eliminate what seems to be an unnecessary procedure of initial payment of the excise tax and subsequent rebate once the part is sold to a final purchaser for use on or in connection with an automobile bus.

The Treasury Department has agreed with me that this technical correction is appropriate as an amendment to the Technical Corrections Act. I would also ask that Assistant Secretary Donald Lubick's letter to me in this regard, which contains the appropriate language for such a change, be included in the record.

With best wishes and kindest personal regards, I am

Sincerely,

HERMAN E. TALMADGE.

DEPARTMENT OF THE TREASURY,
Washington, D.C., November 16, 1979.

Hon. HERMAN E. TALMADGE,
U.S. Senate, Washington, D.C.

DEAR SENATOR TALMADGE: I think the current law exemption for bus parts could be improved as suggested by you in your letter of October 30. Providing exemption for sales and resale would eliminate the need for the credit and refund procedures now required where one or two distributors are interposed between the manufacturer and the bus operator. Since the exemption was part of the Energy Tax Act of 1978, it would be an appropriate amendment to the Technical Corrections Act.

Amending section 4221(e)(6) along with the following line should provide the relief you suggest.

"(6) Bus parts and accessories. Under regulations prescribed by the Secretary, the tax imposed by section 4061(b) shall not apply to any part or accessory which is sold for use by the purchaser on or in connection with an automobile bus, or is to be resold by the first purchaser, or a second purchaser, for such use."

Sincerely,

DONALD C. LUBICK.

U.S. SENATE,
Washington, D.C., November 6, 1979.

Hon. RUSSELL LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: I am writing to ask that the Committee on Finance clarify language enacted by the Revenue Act of 1978 which created a new section 126 of the Internal Revenue Code relating to exclusion from gross income of certain cost-sharing payments.

This section, created by an amendment I introduced to the Revenue Act of 1978, excludes from gross income payments made under nine federal cost-sharing programs designed to conserve soil, protect or restore the environment, improve forests or provide habitat for wildlife. It also excludes from gross income state program payments made for these same purposes. In all cases, the exclusion applies only to payments which the Secretary of Agriculture determines are made for measures contributing *primarily* to these purposes and which the Secretary of the Treasury determines do not add substantially to the annual income derived from the property affected.

It was certainly my intent at the time to remove from all public cost-sharing programs of this nature the disincentive to cost-effective use of these funds created by existing tax treatment. There appears now to be some uncertainty as to whether or not the language of my amendment would exclude from gross income payments made under programs authorized and funded solely by counties and other political subdivisions of the states.

In order to clarify this matter, I urge the committee to modify the language of section 126(a)(10) to specifically include political subdivisions of states. I have attached language which I believe accomplishes this and offer it for your consideration.

I appreciate your assistance on this matter and ask that this letter be made a part of the hearing record on H.R. 2797, an act to make technical corrections related to the Revenue Act of 1978.

Sincerely,

JOHN C. CULVER.

TECHNICAL CORRECTION OF SECTION 126(a)(10), INTERNAL REVENUE CODE, RELATING TO CERTAIN COST-SHARING PAYMENTS—(SEC. 543, 1978 ACT)

(10) Any [State] program *authorized by a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia* under which payments are made to individuals primarily for the purpose of conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

PREPARED STATEMENT OF SENATOR BIRCH BAYH

Mr. Chairman, I am requesting your consideration of a provision which I feel is properly the subject of the Technical Corrections Act as well as a paragraph which would be appropriate for the Committee Report accompanying that Act.

PROPERTY ACQUIRED FOR LEASE TO ANOTHER AS A FINANCING TRANSACTION NOT TO BE COUNTED AS CAPITAL EXPENDITURES IN COMPUTING LIMITS ON TAX EXEMPT INDUSTRIAL DEVELOPMENT BONDS

Last year the provisions of the Internal Revenue Code with respect to tax exempt industrial development bonds were changed to raise from $5 million to $10 million, the maximum amount of capital expenditures (including the face amount of the bond issue) which a company could make with respect to facilities in the same jurisdiction over a six year period. Those provisions also excluded another $10 million of capital expenditures if the bond issue was to provide facilities with respect to which an Urban Development Action Grant had been made.

However, since that time, I have learned that the Internal Revenue Service has taken the position that purchase and lease arrangements which substitute as financing transactions for the customers of financial institutions are "capital expenditures with respect to facilities", and that the financial institutions are deemed to be the principal users of these facilities by the I.R.S. I do not think that such a broad interpretation of capital expenditures with respect to facilities was over contemplated by Congress or that the financial institutions are the principal users in these leasing arrangements.

Such an interpretation has the effect of denying the benefit of tax exempt industrial development bonds to many financial institutions simply because they use long-term leasing as an alternative to traditional methods of financing for their customers. Financial institutions frequently "acquire" property from a seller to lease to a buyer instead of providing the buyer a loan to buy the seller. It is the lessee who takes possession and uses the property, not the financial institution. These purchases and lease transactions should not be considered as capital expenditures with respect to facilities for use by the financial institution, but simply as a way of financing a buyer's purchase from the seller.

To count these transactions as capital expenditures as the I.R.S. does, unnecessarily limits the use of tax exempt securities under the 1978 amendments. Consequently, I am asking that the attached provision be inserted in the Technical Corrections Act so that acquisition of personal property will not be considered as a capital expenditure with respect to facilities when it is leased to a third party for over half of its useful life.

The effective date of this provision corresponds to the interpretation presently being placed on the effective date of Sec. 331(c)(2)(B) by the I.R.S., and the effective date of that section is amended to clarify that that interpretation is indeed the law.

LIMITS ON PRIVATE CAPITAL EXPENDITURES RELATIVE TO THE SIZE OF URBAN DEVELOPMENT ACTION GRANTS FOR PURPOSES OF THE $10 MILLION CAPITAL EXPENDITURE EXCLUSION

I have also become aware that the I.R.S. is seeking to establish a limit over the size of private capital expenditures relative to the size of the Urban Development Action Grant, above which Section 103(b)(6)(I) (which provides the additional $10 million exclusion) would not be operative. While some limit may be necessary to prevent the case of a truly insignificant Urban Development Grant from triggering the operation of this section, our intent has always been to encourage sizeable private capital expenditures in response to an Urban Development Action Grant rather than to discourage such a response.

Consequently, I would ask that language be added to the Committee Report on the Technical Corrections Act which would say in effect:

"It is not necessary that the Urban Development Action Grant be of a certain size relative to the size of private capital expenditures in order to trigger the operation of Section 103(b)(6)(I) so long as that grant does not constitute an insignificant contribution to the total project. Arbitrary ratios should not disqualify projects in which twenty or thirty times as much private capital has been invested in the project."

TECHNICAL NATURE OF THESE CHANGES

Mr. Chairman, you asked that statements deal with the question of whether these amendments are technical changes or policy changes:

With respect to purchase and lease arrangements being treated as capital expenditures with respect to facilities, the law was amended in 1978 to substantially expand the amount of capital expenditures which could be made and still qualify for tax-exempt status. The recent denial by the I.R.S. of a ruling that such transactions were not capital facilities indicates that the Treasury is seeking to restrict application of the 1978 changes by expanding the definition of "capital expenditures with respect to facilities" to include transactions which were never intended to be included by Congress. The language of the proposed amendment clarifies that these purchase and lease arrangements are not capital expenditures with respect to facilities by specifically saying that these purchase and lease arrangements are not to be taken into account as capital expenditures.

With respect to the ratio of private expenditures to the size of Urban Development Action Grants, the 1978 Revenue Act made no mention of such a ratio. The language suggested for inclusion in the Committee Report continues that policy and says that there should not be any limit except for insignificant sized grants. It says that 20-1 or 30-1 ratios should not disqualify a project. This language simply reaffirms what the law already says.

CONCLUSION

Mr. Chairman, I very much appreciate your consideration of these matters which are important to the Urban Development Action Grant program in both Indiana and elsewhere.

079610.290

AMENDMENT NO. ___ Calendar No. ___

Purpose: To provide that capital expenditures for lease property are not taken into account in applying the small issue exemption rules to industrial development bonds, and to change the effective date for the section 331 amendments relating to such bonds.

IN THE SENATE OF THE UNITED STATES--96th Cong., 1st Sess.

H.R. 2797

To make technical corrections related to the Revenue Act of 1978.

Referred to the Committee on ______________________________ and ordered to be printed

Ordered to lie on the table and to be printed

Amendments intended to be proposed by Mr. Bayh

Viz:

1 On page 37, between lines 20 and 21, insert the
2 following:
3 (7) Amendments relating to section 311 of the Act.--
4 (A) Acquisition of property for leasing not
5 treated as capital expenditure.--Subparagraph (F) of
6 section 103 (b) (6) (relating to certain capital
7 expenditures not taken into account) is amended--
8 (i) by striking out ''or'' at the end of
9 clause (ii),
10 (ii) by inserting ''or'' at the end of clause
11 (iii), and
12 (iii) by inserting immediately after clause
13 (iii) the following new clause:
14 ''(iv) to acquire personal property for
15 lease by the person acquiring the property in
16 a transaction involving a lease term in
17 excess of 50 percent of the useful life of
18 the property,''.
19 (B) Change in effective date for Revenue Act of
20 1978 amendments.--Paragraph (2) of section 331 (c) of
21 the Revenue Act of 1978 (relating to effective date)

1 is amended to read as follows:

2 ''(2) The amendment made by subsection (b) shall apply to
3 obligations issued after September 30, 1979, in taxable years
4 beginning after that date.''.

5 (C) Effective date.--The amendments made by
6 subparagraph (A) shall apply to obligations issued
7 after September 30, 1979, in taxable years ending
8 after such date.

9 On page 37, line 21, strike out ''(7)'' and insert in
10 lieu thereof ''(8)''.

11 On page 38, line 13, strike out ''(8)'' and insert in
12 lieu thereof ''(9)''.

13 On page 39, line 1, strike out ''(9)'' and insert in lieu
14 thereof ''(10)''.

15 On page 39, line 16, strike out ''(10)'' and insert in
16 lieu thereof ''(8)''.

17 On page 41, line 4, strike out ''(11)'' and insert in
18 lieu thereof ''(12)''.

19 On page 41, line 10, strike out ''(12)'' and insert in
20 lieu thereof ''(13)''.

21 On page 41, line 17, strike out ''(13)'' and insert in
22 lieu thereof ''(14)''.

TECHNICAL EXPLANATION OF THE AMENDMENT TO SECTION 103(b)(6)(F)

Many banks and other financial institutions now use long-term leasing as an alternative to traditional methods of property financing. Typically, leases are utilized where a person wishes to finance the full purchase price of the property. The cash flow of the person wishing to use the property may make it difficult to make an initial down payment of sufficient size to otherwise acquire such property, or for a number of reasons, the person may not want to acquire title to capital assets.

While the acquisitions by the financial institutions of properties to be leased in these transactions are treated as capital expenditures for Federal income tax purposes, the transactions are the equivalent of traditional methods of financing to both the lessors and the lessees. The only difference is that instead of lending money which the borrower uses to buy the property he needs, the financial institution (or a subsidiary formed for this purpose) acquires title to the property and immediately leases it to the person who will use it and who, but for the availability of these leasing transactions, would be borrowing the money. The terms of these leases normally cover the same time period in which a borrower would be expected to repay a similar loan. Furthermore, the financial institutions virtually never take actual possession of the properties so purchased, unless the lessees fail to make the rental payments.

The Internal Revenue Service has taken the position, in denying requests for private letter rulings, that both the lessors and the lessees in these transactions are "principal users" of the property so leased so that the capital expenditures of the financial institutions in acquiring such properties are included in determining the amount of the Industrial Development Bonds which may be issued for their use under section 103(b)(6)(D). This has the effect of denying the benefits of this section to large numbers of financial institutions across the country which engage in such transactions.

The proposed amendment changes this result by excluding from consideration under section 103(b)(6)(D)(ii) those capital expenditures made to acquire properties for lease in transactions which are functionally equivalent to loans. Where property is acquired for lease to a specific person for a term covering the majority of the property's useful life, it is appropriate to treat the lessee and not the lessor as the principal use of the property. It is the lessee who takes possession of the "uses" the property in every sense of the word.

The statutory amendment does not cover the type of leasing transactions in which the purchaser maintains an inventory of items for short-term lease on a need basis. In such transactions the lessor's interests in the property is more than that of a mere titleholder and the lessor's activities in connection with the property (such as storing and maintaining the property) make it appropriate to designate him as a "principal user."

SUPPLEMENTARY TESTIMONY OF SENATOR BIRCH BAYH

Mr. Chairman, manufacturers of ambulances from truck chassis face a peculiar situation caused by a technicality in the manufacturers Excise Tax which I believe and which the Treasury believes should be corrected.

Present law exempts the sales of ambulances from the 10% Manufacturers Excise Tax. However, if a manufacturer converts a small truck chassis into an ambulance, the purchase of the chassis for the ambulance is taxed. This could potentially create a serious problem for a company which is not vertically integrated because a competitor which made both the chassis and the ambulance would not be subject to the excise tax at any stage of production.

Up until recently this anomaly in the law has not been a significant problem for these manufacturers because in the past most ambulances have had a gross weight of less than five tons. Purchases of truck chassis for use with a vehicle having a gross vehicle weight rating under five tons are presently exempt under Section 4061(a)(2). However, equipment and safety requirements for ambulances are beginning to result in the use of chassis which have ratings which exceed the five ton limit.

In order to correct this problem, the Manufacturers Excise Tax should be amended to allow a refund for those excise taxes paid on chassis sold for use by the purchaser as the chassis of an ambulance, hearse, or combination ambulance-hearse. This approach was recommended by Daniel I. Halperin, Deputy Assistant Secretary of the Treasury who indicated that "we will be glad to recommend approval if our opinion is requested by the Senate Finance Committee."

Mr. Chairman, you asked that statements deal with the question of whether proposed amendments are technical changes or policy changes. As a practical mat-

ter, up until recently most chassis used in making ambulances have not been taxed. This provision merely makes the law consistent with past practice and prevents a change in policy that would tax chassis used in making ambulances whereas they had not been taxed before.

The only change being made is a recognition that the reality of changing ambulance weights creates a discontinuity in present law which results in taxation if two different manufacturers make the product, but exemption if that product is completed by one manufacturer. The law has not changed, but changes in ambulance regulations have caused ambulances to change creating an anomaly in the law which should be changed. This amendment is an attempt to avoid changing our stated policy of not taxing the manufacture of ambulances.

Mr. Chairman, both the proposed amendment and Mr. Halperin's letter are attached. I hope you would see fit to include this amendment in the Technical Corrections Act.

AMENDMENT NO. ___ Calendar No. ___

Purpose: To provide a credit or refund of excise tax paid with respect to chassis sold for conversion into ambulances.

IN THE SENATE OF THE UNITED STATES--96th Cong., 1st Sess.

H.R. 2797

To make technical corrections related to the Revenue Act of 1978.

Referred to the Committee on ______________________________ and ordered to be printed

Ordered to lie on the table and to be printed

Amendments intended to be proposed by Mr. Bayh

Viz:

1 On page 79, between lines 6 and 7, insert the following:

2 (6) Paragraph (2) of section 6416 (b) (relating to

3 special cases in which tax payments are considered

4 overpayments) is amended by redesignating subparagraphs

5 (L) and (M) as (M) and (N), respectively, and by

6 inserting after subparagraph (K) the following new

7 subparagraph:

8 ''(L) in the case of a chassis taxable under

9 section 4061 (a), sold for conversion to, or use as

10 part of, an ambulance, hearse, or combination

11 ambulance-hearse;''.

12 On page 79, line 7, strike out ''(6)'' and insert in lieu

13 thereof ''(7)''.

14 On page 79, line 10, strike out ''(7)'' and insert in

15 lieu thereof ''(8)''.

BEST COPY AVAILABLE

DEPARTMENT OF THE TREASURY,
Washington, D.C., July 11, 1979.

Hon. BIRCH BAYH,
U.S. Senate, Washington, D.C.

DEAR SENATOR BAYH: The situation with respect to the taxation of truck chassis used to make ambulances and hearses is substantially as described by Mr. Andrew C. Cecere in his letter of May 23 which you attached to your transmittal of June 11. As Mr. Cecere indicated, we believe rectification of the situation requires legislation.

One way of achieving the refund referred to by Mr. Cecere is by adding a new paragraph to section 6416(b)(2) of the Internal Revenue Code to read as follows: "(N) in the case of a truck chassis taxable under section 4061(a), sold for use by the purchaser as the chassis of an ambulance, hearse, or combination ambulance-hearse."

If you wish to introduce a bill to this effect, we will be glad to recommend approval if our opinion is requested by the Senate Finance Committee. I would, however, like to retain the right to suggest technical changes in the wording.

Sincerely,

DANIEL I. HALPERIN,
Deputy Assistant Secretary (Tax Policy).

ROBERT M. GANTS, DIRECTOR, U.S. AND OVERSEAS TAX FAIRNESS COMMITTEE, AND VICE PRESIDENT, GOVERNMENT RELATIONS, NATIONAL CONSTRUCTORS ASSOCIATION

I am Robert M. Gants. I'm here today as Director of the U.S. & Overseas Tax Fairness Committee. As you may know, the Tax Fairness Committee (TFC) has been active for over two years in support of new legislation aimed to put American citizens at work overseas on competitive tax footing with citizens from all of the other industrial nations—all of whom have been increasing their international market shares at our expense in recent years.

The fact is that American citizens—due in large measure to improvident and unrealistic U.S. tax policies—are no longer price-competitive overseas.

I might add that I also speak today for the National Constructors Association (NCA). NCA, of which I am Vice President for Government Relations, represents 54 of the nation's largest engineering and construction firms. Among other things, those firms account for as much as 80% of our nation's overseas engineering and construction volume. It has been estimated, conservatively, that at least 400,000 jobs are created in this country—in our domestic economy—as a direct result of overseas contracts held by U.S. engineering and construction firms.

Both the TFC and NCA had hoped that the Foreign Earned Income Act of 1978 would go a long way toward the goal of restoring U.S. citizens to competitive tax footing overseas.

But, as I'm sure you know, it is proving less than adequate. Worse, the IRS has chosen to be very restrictive in its interpretations of the Foreign Earned Income Act of 1978. We've had to make quite an effort to keep the IRS from reversing the original intent of the Congress. And I must say that, at this point, we've only been partly successful.

One of the results has been a great deal of uncertainty about our ability to compete in foreign markets. The Bill currently under consideration by your Committee, HR 3874, will not end all of the uncertainty. But it can certainly put an end to one cause of uncertainty.

Under current tax law, if a U.S. citizen fails for any reason to meet overseas residency tests, that citizen loses whatever tax benefits he or she may have had overseas. That is patently unfair in cases where a U.S. citizen is forced to leave a country and return home before he or she can meet the overseas residency requirement due to circumstances completely beyond his or her control.

The developments in Iran over the past nine months present a vivid example: Americans were in Iran in large numbers prior to the over-throw of the shah in January. Many who were newly assigned and had every expectation of remaining to complete their residency requirements under Sections 911 and 913 of the Tax Code, were forced to leave.

We don't yet know exactly how many U.S. citizens working in the private sector in Iran were affected by the sudden upheaval in Iran. We can report on a number of specific cases, however.

For example, one of our member firms, Morrison-Knudsen, reports that it had 160 Americans in Iran when the upheavals took place. Most were evacuated. We do not

know how many of those had yet to meet the overseas residency tests. Our informed estimate is less than one-third.

We've been in touch with many of our member firms over the past few weeks to see how many of their overseas employees would be benefited, right now, by S 873. Let me simply quote a few of the responses we've had:

From Dames and Moore: "Dames & Moore had six expatriate employees affected by the insurrection in Iran."

From Kaiser Engineers: "Six employees of Kaiser Engineers repatriated from Iran would be benefited by the proposed waiver of residency requirements for 911 and 913."

From Dravo Corporation: "The number of individuals affected is 25 in Iran."

From Fluor Corporation: "Fluor had approximately 125 U.S. employees in Iran in December of 1978. Virtually all of these employees were evacuated in January of 1979. We have no way of knowing how many of these employees fail to qualify under either 911 or 913 because of their early departure."

And on it goes.

Of course, not all of our member firms had American citizens at work in Iran during the upheaval. But several made observations that I'd like to share with you:

From Pullman-Kellogg: "Kellogg has not had expatriates forcibly ousted from foreign countries due to insurrection and civil strife. Our last project in Iran was before the recent crisis. However, we support HR 3874 (S873) since our worldwide operations will no doubt ultimately cause us to be involved in these situations and to disallow the 911/913 benefits would be unfair to the expatriates involved."

From Foster Wheeler Energy Corporation: "Foster Wheeler's U.S.A. companies had no personnel who had to be evacuated as a result of the political upheaval in Iran. Our U.K. affiliate, however, did have to remove approximately 400 supervisory construction staff on several projects in that country. It might be pointed out that had U.S. tax treatment of expatriates been more in line with worldwide practice, a significant number of these might have been from the U.S."

Iran is only one of the more recent examples of political unrest leading to the evacuation of Americans. Last year, for example, one of our member firms, Morrision-Knudsen of Boise, Idaho, had to evacuate 10 of its people from Zaire in Africa. Two of its people, in fact, were killed when one of the work camp locations was overrun. It would be ludicrous if the families of those victims were disqualified from the 911 or 913 benefits because of inflexible application of the residency tests.

Given some of the politically volatile areas of the world in which our member companies work, I think you can readily expect that there will be future forced evacuations of Americans under circumstances that have nothing to do with whether or not they intended to meet the residency requirements for tax purposes.

Intent has to be taken into account. I don't think any American is going take the risks of living in a country that he or she knows is dangerous and likely to go out of control simply to qualify for a few months under 911 or 913. There is no risk that American citizens will attempt to misuse S873 in that way. It wouldn't be worth it.

I must also point out that no additional tax cost is associated with S873. On the contrary, if the IRS were to tax U.S. nationals prematurely forced out of certain countries because of volatile political circumstances that would constitute a tax windfall to the Treasury. Whatever tax costs are associated with 911 and 913—and we don't agree with the way those costs are calculated, in the first place—are based on the assumption that everyone who goes overseas with the intent of remaining long enough to qualify under the foreign residency provisions will qualify. No assumption is made that a certain percentage will be forced to return prematurely due to circumstances beyond their control.

The "cost" of Americans forced out of Iran was surely taken into account by Treasury in its FY 1980 budget calculations.

So, I'm suggesting that S873 is really a reasonable technical correction of an oversight. While the number of U.S. citizens that will be affected by S873 appears to be fairly modest, perhaps 1500 at the most, common sense and common decency suggest that Congress should act quickly to correct the oversight. Certainly, this should not be a controversial issue.

Had we all thought about it at the time, I am confident that both the House and the Senate versions of the Foreign Earned Income Act of 1978 would have included relief of the kind contained in this legislation.

The members of the Tax Fairness Committee and the National Constructors Association wholeheartedly support prompt passage and enactment of S873.

HEATH & BELL,
Indianapolis, Ind., September 18, 1979.

Hon. RICHARD G. LUGAR,
Senate Office Building, Washington, D.C.

DEAR SENATOR LUGAR: Section 366 of the Revenue Act of 1978 significantly changed the treatment of the self-insured medical expense reimbursement plans. Prior to the Act, many small (and some large) businesses maintained a plan under which the employer paid all or part of an employee's medical care. The plans were easy to administer and required a minimum of paperwork or professional advice to establish and maintain. They were totally flexible as to the benefits and coverage, and the only major requirement was that the plans benefit employees, not merely stockholders. The plans could be designed to tie in with other employee benefit programs, including major medical insurance, disability, life insurance, and a whole range of employee fringe benefits in the manner deemed most appropriate and cost effective to the small business employer.

The new rules totally change the old law. In addition to technical flaws, they are a horror story to those who are already overwhelmed by the complexity of our tax laws.

The new rules will have a detrimental effect. Great numbers of plans will be terminated as a result of the new rules, since they make the plans prohibitively expensive for small businesses, both in terms of benefits which must be paid and additional administrative and legal costs. In other words these rules will have exactly the opposite effect that they are intended to have. They will deny benefits to the employees they are suppose to protect. It is little wonder that these rules are faulty as they were adopted without public hearings.

I understand that the Taxation Subcommittee of the Senate Finance Committee will soon begin consideration of the 1979 Technical Corrections Act to correct errors in the 1978 Revenue Act. Section 366 is an error that should be repealed or at least delayed.

The whole area of national health policy is presently under consideration. I urge that Section 366 be repealed, or at least delayed until conscious and reasoned decisions regarding overall health policy can be made.

Sincerely,

R. TERRY HEATH.

MAYER, BROWN & PLATT,
Washington, D.C., November 6, 1979.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: These comments on the Technical Corrections Act of 1979 (H.R. 2797) are submitted on behalf of The ERISA Industry Committee (ERIC), an organization of some 100 major employers which sponsor pension and welfare benefit programs for their employees.

In summary, ERIC urges (1) that section 103(a)(10)(A) be rejected as a major substantive change in the uninsured medical reimbursement plan provisions adopted last year and (2) that section 101(a)(9)(C) be expanded to clarify that major employers can take advantage of the Simplified Employee Pension provisions adopted last year.

UNINSURED MEDICAL REIMBURSEMENT PLANS

The Revenue Act of 1978, which amended Code section 105 to subject to tax amounts received by highly compensated employees from discriminatory uninsured medical reimbursement plans, was silent with regard to withholding on these amounts. The Conference Report, however, explicitly stated that such reimbursements would not be subject to withholding. H.R. Rep. No. 95-1800, 95th Cong., 2d Sess. 254 (1978).

Section 103(a)(10)(A) of the Technical Corrections Act would amend Code section 3401(a)(19) to apply the present withholding requirements to reimbursements paid to highly compensated employees unless "it is reasonable to believe that the employee will be able to exclude such payment or benefit from income". ERIC agrees with the statement in the recent report of the Ways and Means Committee that "it is inappropriate for these amounts to be subject to withholding tax" (H.R. Rep. No. 96-250, 96th Cong., 1st Sess. 47 (1979)) but suggests that the provision would require withholding in many cases where it is not currently required. In any event, the presently proposed provision is unworkable.

Specifically, under the provision in the Technical Correction Act, the employer would have to have reason to believe that a payment is excludable in order to avoid withholding. This requirement will be impossible to apply in practice. In most cases, the determinations whether (a) a plan is discriminatory, (b) a participant is highly compensated, and (c) a particular payment is in part or in full taxable, cannot be made until after the close of the taxable year in which the payment is made. Would an employer have "reason to believe" a payment is excludable if the plan was not discriminatory in the prior year? Would he fail to have "reason to believe" a payment is excludable if the plan was discriminatory in the prior year? Even if it were conceded that a plan will be discriminatory when a payment is made, how could the amount subject to tax, and thus subject to withhold, be determined?

It was for these reasons that the conferees last year determined that withholding was inappropriate for such payments (a conclusion recently restated by the Ways and Means Committee). Accordingly, section 103(a)(10)(A) should be rejected.

SIMPLIFIED EMPLOYEE PENSIONS

Section 101(a)(9)(C) of the Technical Corrections Act would clarify the Simplified Employee Pension provisions added last year to Code section 408(k) by explicitly permitting the exclusion from coverage under such plans of employees who are included in collective bargaining units or who are nonresident aliens. This change is parallel to the existing provisions in Code section 408(k) which permit such employees to be excluded in determining whether a Simplified Employee Pension program is discriminatory.

ERIC endorses this clarification and urges that it be expanded to include the exclusions from coverage permitted under Code section 410(b)(1) to clarify that a Simplified Employee Pension program may be maintained for one division or subsidiary of a controlled group of corporations which maintains other qualified plans for employees of other subsidiaries or divisions within the controlled group.

Under the current provisions govening Simplified Employee Pension programs, an employer offering such a program must provide the program to all employees. Generally, ERIC does not object to this requirement, provided it is limited to the particular corporate entity which adopts the Simplified Employee Pension program and does not extend to all of that entity's affiliates and their employees.

Under Code section 414 (b) and (c), which was enacted by the Employee Retirement Income Security Act of 1974 (ERSIA), all employees of a controlled group of corporations or related partnerships are considered employees of the same employer for purposes of Code section 401(a) and other provisions involving employee benefit programs.

The Conference Report on ERISA endorsed "the interpretation of these provisions expressed by the Ways and Means Committee Report (No. 93-807)". H.R. Rep. No. 93-1280, 93d Cong., 2d Sess. 266 (1974). House Report 93-807 stated that the purpose of these provisions was to prevent controlled groups of corporations or related partnerships from avoiding the discrimination and coverage provisions of ERISA by establishing plans for affiliated entities which contain inordinately large numbers of prohibited group members but not for affiliated entities which contain only rank and file employees. Nonetheless, that Report goes on to state:

"At the same time, however, the committee provision is not intended to mean that all pension plans of a controlled group of corporations or partnerships must be exactly alike, or that a controlled group could not have pension plans for some corporations but not others. Thus, where the corporation in question contains a fair cross-section of high- and low-paid employees (compared to the employees of the controlled group as whole), and where the plan coverage is nondiscriminatory with respect to the employees of the corporation in question, it is anticipated that the Internal Revenue Service would find that the plan met the antidiscrimination tests, even though other corporations in the controlled group had a less favorable retirement plan, or no plan at all. H.R. Rep. No. 93-807, 93d Cong., 2d Sess. 50 (1974); 1974-3 C.B. Supp. 285."

In order to avoid the same abuse (formation of separate corporations and/or partnerships to avoid the antidiscrimination and coverage requirements), the Revenue Act of 1978 amended Code section 414 (b) and (c) to refer to the Simplified employee Pension provisions in Code section 408(k). Because Simplified Employee Pension programs, however, are not subject to the limitations on coverage in Code section 410(b)(1), Code section 414(b) and (c) has been read to require coverage of all employees of the affiliated group of corporations or related partnerships if a single affiliate adopts a Simplified Employee Pension program. Obviously, such a result was not intended and is contrary to the purpose of Code section 414 (b) and (c).

Accordingly, ERIC urges that section 101(a)(9)(C) be amended to allow the exclusions from coverage permitted by Code section 410(b)(1), as well as those permitted by Code section 410(b)(2) (A) and (C).

We would welcome the opportunity to discuss these matters further with the members of the Committee and their staff and to answer any questions which arise.

Respectfully submitted,

JERRY L. OPPENHEIMER.
ROBERT H. SWART.

MAYOR, BROWN & PLATT,
Washington, D.C.; November 13, 1979.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: This supplements our letter of November 6, 1979, on behalf of the ERISA Industry Committee (ERIC). In addition to the two matters raised in the prior letter, ERIC strongly urges that the Technical Corrections Act conform the treatment under the Internal Revenue Code of retirement plans maintained for nonresident aliens to the existing exemption of such plans from Title I of the Employee Retirement Income Security Act of 1974 (ERISA).

Deductions to retirement plans maintained by United States persons for nonresident aliens should not depend upon whether the plan meets ERISA standards. Indeed, plans "maintained outside the United States primarily for the benefit of persons substantially all of whom are nonresident aliens" are exempt by section 4(b)(4) of ERISA from all requirements of Title I of ERISA. There is, however, no parallel provision in the Code. ERIC submits that had Congress had the time to focus adequately on the matter, such plans would have been exempted from the ERISA amendments to the Code.

The Internal Revenue Service currently requires that Forms 5500 be filed with regard to foreign plans if a deduction is claimed for contributions to them and has taken the position in private letter ruling 7904042 that a U.S. employer may deduct contributions to a foreign plan only if the plan is a fully qualified plan, *i.e.*, it complies with all of the amendments to the Code made by Title II of ERISA, or if the very limited exceptions in Code section 404(a)(4) or (5) or ERISA section 1022(j) apply. In addition, in view of private letter ruling 7904042, it is possible that the Service will attempt literally to apply the Code to the end that the income from trusts which are a part of nonqualified foreign plans could be taxed to employers under Code section 679.

The ERISA Conference Report suggests that the Code does not exempt foreign plans from the ERISA standards because "such plans would have no need to seek tax deferral qualification". H.R. Rep. 93-1280, 93d Cong., 2d Sess. 291 (1974). This analysis is, at best, incomplete; it ignores the problems of deduction of contributions to foreign plans and of taxation to U.S. employers of the income of such plans and the fact that foreign plans often cannot comply with the ERISA requirements.

Obviously, when Title II of ERISA added the ERISA requirements to the Code, the requirements of section 404(a) became much more extensive, exacerbating the problems asociated with imposing U.S. standards on foreign plans maintained for nonresident aliens. For example, in Canada, the employee must be given the option to elect a joint and survivor annuity; under Code section 401(a)(11), as added by ERISA, the employee must be given the joint and survivor annuity unless he elects otherwise. Thus, it is impossible to comply with both laws. As a further example, technical advice memorandum 7839005 deals with the practice in Germany of funding plans through reserve accounts, rather than trusts, which are uniquely a concept of English common law, unrecognized in Germany and many other countries. Similarly, Jamaican authorities have objected to plans which incorporate provisions required by ERISA. Problems have also arisen under the laws of other countries which conflict with ERISA.

Accordingly, ERIC strongly urges the adoption of a technical amendment to correct the oversight in ERISA by conforming the Code to Title I of ERISA. Attached is such an amendment. It would assure that contributions to foreign plans maintained primarily for the benefit of nonresident aliens are deductible and that the income from these plans is not taxed to U.S. employers.

In addition, much of the information on present Form 5500 relates to ERISA requirements and has no application to foreign plans. Therefore, ERIC suggests that the legislative history should contain a statement along the following lines:

"It is recognized that the Internal Revenue Service has the authority to require information returns regarding plans maintained primarily for nonresident aliens. It is the Committee's intent that any such returns be summary in form and require only that the employer claiming the deduction certify that the plan to which the contribution is made meets the requirements of amended Code section 404(a). Of course, on audit, any such employer would be required to produce information sufficient for the Service to verify compliance."

We would welcome the opportunity to answer any questions from the Committee or its staff.

Respectfully submitted,

JERRY L. OPPENHEIMER.
ROBERT H. SWART.

SEC.—. TRUSTS CREATED OR ORGANIZED OUTSIDE THE UNITED STATES

(a) *General Rule.*—Section 404(a)(4) of the Internal Revenue Code of 1954 (relating to deductions for contributions of an employer to trusts created or organized outside of the United States) is amended to read as follows:

"(4) *Trusts Created or Organized Outside the United States.*—

"(A) *In General.*—Contributions to a stock bonus, pension, or profit-sharing trust by an employer which is a resident, or corporation, or other entity of the United States shall be deductible under the proceeding paragraphs if—

(i) the trust would qualify for exemption under section 501(a) except for the fact that it is a trust created or organized outside the United States; or

(ii) such trust is part of a plan maintained outside of the United States primarily for the benefit of persons substantially all of whom are nonresident aliens, and, under the law of a foreign country or under the governing instrument of the plan, it is impossible, at any time prior to the satisfaction of the claims of the participants and beneficiaries of the plan, for any part of the contributions made in any taxable year or any income therefrom to revert (within the taxable year or any subsequent taxable year) to the employer or any person which is a member of a controlled group with (within the meaning of section 414(b)) or under common control with (within the meaning of section 414(c)) the employer.

"(B) *Special rule.*—A reserve account created in accordance with the law of a foreign country for the purpose of meeting obligations to pay benefits in the future to terminated employees or their beneficiaries shall be treated as a trust, and additions to such reserve account shall be treated as contributions paid to such a trust for purposes of this section."

(b) *Effective date.*—The amendment made by this section shall apply to taxable years ending after August 31, 1974.

NATIONAL ASSOCIATION OF HOUSING & REDEVELOPMENT OFFICIALS,
Washington, D.C., November 7, 1979.

Hon. HARRY FLOOD BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management Generally, Senate Finance Committee, Washington, D.C.

DEAR MR. CHAIRMAN: The Subcommittee on Taxation and Debt Management Generally of the Senate Finance Committee is considering the Technical Corrections Act of 1979 (S. 614) and certain amendments thereto. It is the purpose of these comments, submitted on behalf of the National Association of Housing and Redevelopment Officials ("NAHRO") to urge the amendment of S. 614 to correct what we understand to be an oversight on the part of the House of Representatives in passing H.R. 2797. The oversight to which we refer is the failure of H.R. 2797 to remove restrictions on the availability of the investment tax credit ("ITC") for qualifying rehabilitation expenditures made with respect to older commercial buildings leased to federal, state and local government agencies and tax-exempt organizations.

Under the Revenue Act of 1978, Congress extended the ITC to qualifying rehabilitation expenditures made with respect to commercial buildings over 20 years old. The General Explanation of the Revenue Act of 1978 notes that it was the intention of the Congress to promote the renovation and modernization of older buildings throughout the country, particularly in central cities and in older, declining neighborhoods of all communities. However, the Revenue Act of 1978 failed to coordinate the extension of the ITC to qualifying rehabilitation expenditures with those general restrictions on the avalability of the ITC which existed prior to its enactment. As

a result of these pre-Revenue Act of 1978 restrictions, the ITC is presently not available for qualifying rehabilitation expenditures made with respect to older commercial buildings (i) leased by a noncorporate lessee under a net lease, (ii) leased to a federal, state or local government agency or instrumentality, or (iii) leased to a tax-exempt organization.

The Technical Corrections Act of 1979, S. 614, pending before your Subcommittee eliminates only the first of these three restrictions (net leases by non-corporate lessees). (See Section 103(a)(3)(A) of the Technical Corrections Act of 1979 and Section 46(e)(3) of the Internal Revenue Code of 1954.) The House Ways and Means Committee Report on H.R. 2797 states that the elimination of this restriction involving net leases by noncorporate lessees is designed to correct the "unintended result" of applying this restriction to qualifying rehabilitation expenditures for older buildings. The Committee Report further states that to permit this restriction to stand would cause an unintended dimumition of the stimulative impact of extending the ITC to the rehabilitation of older buildings particularly in those central city areas and declining neighborhoods where such buildings are vacant and make no contribution to the area's or neighborhood's economic base.

While H.R. 2797 addresses and eliminates the first of the three general restrictions on the availability of the ITC to the rehabilitation of older commercial buildings, H.R. 2797 fails to eliminate the remaining two restrictions on the availability of the ITC for rehabilitated older buildings mentioned above, i.e., where such buildings are leased to federal, state or local government agencies and where they are leased to tax-exempt organizations. In light of the House Ways and Means Committee's Report on H.R. 2797 stating the Congressional intention to stimulate the rehabilitation of older commercial buildings through use of the ITC, it would appear that the failure to address and eliminate these restrictions in H.R. 2797 was an oversight.

As you are likely aware, a disproportionately large percentage of leasing of rehabilitated older buildings in central city areas and older, declining neighborhoods is with government agencies and tax-exempt organizations. Often these same government agencies and tax-exempt organizations have been instrumental in initiating, encouraging or directly assisting in the redevelopment of such areas and neighborhoods and in the renovation of their older buildings. There are literally hundreds of examples where federal, state or local government agencies or tax-exempt organizations have manifested their commitment to the redevelopment of declining neighborhoods and to the renovation of older buildings by locating and leasing in such neighborhoods and buildings. This commitment by goverment agencies and the tax-exempt organizations to locate and lease in such neighborhoods and renovated buildings has not only proven to be a catalyst for private investment but in many instances has broken the barrier of private sector resistance to locate and lease in such neighborhoods and buildings. It is precisely this type of relocation and leasing action by government agencies and tax-exempt organizations that has caused individual buildings, declining neighborhoods and central city areas to "turn around" through the infusion of private investment capital and private interest.

To impede or restrict the stimulus of federal, state or local government agency and tax-exempt organization leasing and relocation to renovated buildings in such neighborhoods or areas is clearly contrary to Congressional intent.

In addition, it is well known that federal, state and local government agencies and tax-exempt organizations, in general, are highly budget conscious. As a result, they often seek to lease buildings which are not the newest or located in the most prime areas. Consequently, older, renovated buildings somewhat removed from prime, downtown commercial locations are often sought after by government agencies and tax-exempt organizations for leasing. It would work a disadvantage to such government agencies and tax-exempt organizations if private investment capital seeking the ITC as an incentive to rehabilitate older buildings in marginal areas or neighborhoods either refused to lease to government agencies or tax-exempt organizations due to loss of the ITC or charged government agencies and tax-exempt organizations higher rents to compensate for the loss of ITC. In the case of federal government such a result would run directly contrary to the Economy Act of 1932 and the Public Buildings Cooperative Act of 1976.

In order to fully coordinate the extension of the ITC to the rehabilitation of older commercial buildings in a manner consistent with the intent of Congress in its enactment of the Revenue Act of 1978, the Technical Corrections Act of 1979 should be amended to eliminate the restrictions pertaining to leasing to federal, state and local government agencies and tax-exempt organizations. We have attached to these comments suggested amendment language to S. 614 together with a background Memorandum which deals in greater depth with Congressional extension of the ITC

to the rehabilitation of older commercial buildings, the three existing restrictions on the availability of the ITC, H.R. 2797's elimination of the first of these restrictions, and further support and justification for the elimination of the remaining two restrictions.

Very truly yours,

ROBERT W. MAFFIN,
Executive Director.

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Technical Corrections Act of 1979
S. 614

Section 103. Amendments Related to Title III.

(a) General Rule

* * *

(3) Amendments Related to Section 315 of the Act. --

(A) * * *

(B) * * *

[New] (C) Property Used By Certain Tax-Exempt Organizations -- Paragraph (4) of Section 48(a) (relating to special rule for property used by certain tax-exempt organizations) is amended by adding at the end thereof the following new sentence: "This paragraph shall not apply with respect to any property which is treated as section 38 property by reason of section 48 (a)(1)(E)."

[New] (D) Property Used By Governmental Units -- Paragraph (5) of section 48(a) (relating to special rule for property used by governmental units) is amended by adding at the end thereof the following new sentence: "This paragraph shall not apply with respect to any property which is treated as section 38 property by reason of section 48(a)(1)(E)."

This amendment shall be effective as if included in the Revenue Act of 1978 (PL 95-600).

MEMORANDUM

Re: Proposal to Remove Certain Excluded Tenancies from Qualifying for Investment Tax Credit on Rehabilitated Buildings

Date: October 30, 1979

Background Information

As part of the Revenue Act of 1978, Congress amended Code Section 48(a)(1) to add a new subparagraph (E). In general, subparagraph 48(a)(1)(E) provides that in the case of a qualified rehabilitated building, that portion of the basis which is attributable to qualified rehabilitation expenditures shall be treated as "Section 38 property". The effect of this provision is to make the investment tax credit available for certain rehabilitation expenditures made with respect to buildings which are at least 20 years old at the time the rehabilitation occurs.

The Congressional purpose in enacting this subparagraph is reflected in the General Explanation of the Revenue Act of 1978, the relevant portion of which is attached as an exhibit to this memorandum. To paraphrase the General Explanation, the investment tax credit was originally enacted in 1962 as a result of Congressional concern about the substantially greater average age and lower efficiency of domestic manufacturing facilities *vis a vis* foreign manufacturers. The invest-

ment tax credit was designed to spur investment in domestic production facilities in order to enable domestic manufacturers to compete more effectively with foreign producers.

Presently, a similar concern exists about the declining usefulness of existing, older buildings throughout the country, primarily in central cities and older neighborhoods of all communities. In enacting § 48(a)(1)(E), Congress evidenced a belief that it was appropriate to encourage business to rehabilitate and modernize existing structures. Congress believed that the change in the investment tax credit would promote greater stability in the economic vitality of areas that have been deteriorating.

The Problem

Unfortunately, as a result of certain general restrictions on the application of the investment tax credit which existed prior to the enactment of § 48(a)(1)(E), this new provision may be largely vitiated unless further changes in the law are made. These restrictions are that the investment tax credit is generally unavailable with respect to: (i) property owned by a non-corporate lessor and subject to a long-term net lease; (ii) property used by the federal government, a state or local government or instrumentality

thereof; and (iii) property used by a tax-exempt entity, unless the property is used by the tax-exempt entity in an unrelated trade or business. The first of these problems is presently under consideration by Congress. The pending legislation does not address itself to the second and third problems.

Analysis

In the Technical Corrections Act of 1979 (H.R. 2797 and S. 614) now pending before the Senate, several changes are made with respect to the investment tax credit for rehabilitated property. One of these changes would eliminate the restrictions with respect to non-corporate lessors for purposes of the investment tax credit for rehabilitation expenditures. (Section 103(a)(3)(A) of the Technical Corrections Act of 1979 (hereinafter "the Act") and Section 46(e)(3) of the Internal Revenue Code of 1954 (hereinafter the "Code")). The House Ways and Means Committee Report on H.R. 2797 notes that the Revenue Act of 1978 did not contain any provisions to coordinate the extension of the credit to building rehabilitations with the non-corporate lessor limitation. The Bill is intended to correct what is stated to be an "unintended result" of applying the non-corporate lessor restriction to rehabilitation

expenditures. The stated reasons for the change are that in the case of the rental of commercial buildings, the use of net lease arrangements is traditional and customary. The application of the non-corporate lessor limitations would deny the investment tax credit in many situations where taxpayers have incurred substantial expenditures in rehabilitating older buildings. The Report states that application of this restriction would cause an unintended dimunition of the stimulative impact of extending the credit to rehabilitated buildings, particularly in urban areas where older buildings are presently vacant and make no contribution to the area's economic base.

Apparently, in enacting the Revenue Act of 1978, as well as in its consideration to date of the Technical Corrections Bill of 1979, Congress has overlooked the strong probability that a disproportionately large percentage of tenants in a rehabilitated commercial building will be governmental agencies or instrumentalities and/or tax-exempt entities. This oversight, like the oversight regarding non-corporate lessors in the enactment of the Revenue Act of 1978, may result in an unintended lessening of the stimulative impact of the investment credit for rehabilitated buildings. Code Sections 48(a)(4) and (5), respectively, deny the investment

tax credit to property used by an organization which is exempt from tax (unless such property is used predominantly in an unrelated trade or business) and to property used by governmental units.

Such a result is inconsistent with other previously expressed federal policy. In leasing buildings for federal government use, the Space Management Division of the Public Buildings Service of the General Services Administration (GSA) is governed by several different statutes, the most important of which is the Economy Act of 1932. 40 U.S.C.A. § 278(a) (West).

The Economy Act establishes a maximum rental formula for lease agreements to which the federal government is a party. According to the Act, the government cannot pay more than the appraised fair annual rental value as determined by government appraisers; and, in no event may the government pay more than 15 percent per annum of the fair market value of the rental premises at the date of the lease.

The Economy Act may never be waived; compliance is mandatory.

Recently, in enacting the Public Buildings Cooperative Use Act of 1976, 40 U.S.C.A. § 490; 601(a); 606; 612(a),

Congress reconfirmed its policy that the federal government seek to occupy older and rehabilitated space. This Act directs the GSA Administrator to acquire space for Federal offices in buildings of historic, architectural or cultural significance, unless use of such space would not prove feasible and prudent compared with available alternatives. 40 U.S.C.A. § 601a(a)(1). In order to implement this policy, the Act directs the Administrator prior to undertaking a survey of public building needs of the Federal government within a geographical area to request the Chairman of the Advisory Council on Historic Preservation to identify existing buildings in the community that are of architectural, cultural or historic interest and suitable for Federal office space. 40 U.S.C.A. 611(c).

When interpreted within the context of its legislative history, the Public Buildings Cooperative Use Act becomes quite definite and specific in its scope and purpose. A renovation, as is generally known, eliminates much of the expenditure needed to tear down and replace older buildings. In testifying to the Public Works Committee, (S. Rep. No. 94-349, 94th Cong., 1st Sess. 1975), the GSA noted that it is generally cheaper to refurbish than to replace

and the work can usually be accomplished far more expeditiously than demolition and new construction. The Senate Report further emphasized that the Act was not an effort to select one or two isolated historic buildings for renovation, but rather a call to GSA to take affirmative action in finding opportunities for renovation in many older rundown office buildings, warehouses, railway stations and theatres. Id.

The issue of justification of the legislation on an economic basis was addressed in the presentation of the Act on the floor of the Senate. Senator Stafford, as co-sponsor of the bill, submitted for the record excerpts from the Staff Report of the Federal Architecture Task Force stating that, "adaptive use can be an effective tool for meeting Federal space needs while achieving policy objectives of cost savings, efficient use of finite resources and the conservation of America's cultural heritage." 121 Cong. Rec. 26742, 26747 (1975). In support of this conclusion, the Staff Report cited economic pressures of recent years that have affected the construction industry. Inflation and scarcity in energy and materials have significantly increased construction costs. A shortage of lending dollars for new construction provides additional encouragement for small scale remodeling.

Recent recycling projects cited by the Staff Report illustrate the cost savings made possible by reuse:

(1) The conversion cost of Boston's Chickering Piano Factory completed in 1974 was $12.50 per square foot; less than half the projected cost of similar new construction.

(2) The Paramount Theatre of the Arts in Oakland reopened as a performing arts center in 1973. The building's conversion was completed in less than two years for under $2 million compared to the estimated $13 million projected cost for a new center.

(3) The Virginia General Assembly approved the renovation of the Life of Virginia Insurance Building for office space for $5 million, a price far below estimates for new construction. Id. at 26747.

Also preserved for the record in the Senate debate were remarks by Anthony J. Newman of the New York landmarks conservancy which reinforced the findings of the Staff Report. He stated that aside from site acquisition which is a given in both situations, the cost of constructing new office space in New York City will average $50.00 per square foot. Assuming structural soundness and the same market, the cost per square foot of rehabilitated office space can be as low as $30.00 per square foot -- a 40 percent difference. Id. at 26749.

Applying the limitations imposed by the Economy Act, (fifteen percent per annum of fair market value) it can be demonstrated that the annual rental savings to the government of leasing 100,000 square feet of rehabilited space (costing $30 per square foot) compared with leasing the same amount of newly constructed space (at $50 per square foot) would be $300,000. With the government consuming millions of square feet of private office space in Washington alone, the difference in cost to GSA could be enormous. Moreover, from the exhibit attached one can readily determine the number of rather recent renovated historic structures leased by GSA since the 1976 Public Buildings Act. In many of these instances, had the 1978 tax credit extension to real estate been in effect, including its current restrictions against leasing to governmental units, lessors confronted with the alternative of leasing to private lessees at the same (or even lower) rates paid by governmental units, might well have opted in that direction so as to obtain the benefits of the tax credit. This would have closed the door to GSA occupancy of extremely attractive but lower cost space.

Moreover, while continuation of the non-availability of the investment tax credit to lessors leasing to governmental

units and charitable organizations would prove costly to those classes of tenants by drying up the availability of such space to them, removal of the restriction in the law would probably have little effect in terms of lost tax revenues. When the tax credit was extended to real estate in 1978, the Joint Committee Staff made certain estimates of revenue loss. However, it does not appear that those estimates took into consideration the non-availability of the credit where governmental units and charities were tenants. Thus, the projected revenue loss Congress considered in 1978 would appear to be greater than the actual result which will obtain if the exclusion of the credit (where governmental units and charities are tenants) is continued.

In summary, to expand the investment tax credit for the purpose of spurring investors to rehabilitate older real estate but to then make the benefit unavailable to the lessor who seeks a governmental tenant is to defeat the very intent of the change. Once lessors refuse to lease this space to governmental units in order not to lose their tax credit, it will be difficult, if not impossible, for the GSA, which is mandated by other Acts to be in the primary market for older and less expensive space, from filling its needs and thereby complying with long standing Congressional policy. Such a result could not have been intended by Congress.

SWP:sf
Attachments

GENERAL EXPLANATION OF THE REVENUE ACT OF 1978
Prepared by the Staff of the
Joint Committee on Taxation

qualify for the investment credit and would not be considered buildings.[4] The Internal Revenue Service continued to approach the question of eligibility of single purpose farm structures on a case-by-case basis. For example, in three recent cases, the IRS contended that structures which are designed and used for poultry-raising and egg-producing activities were not eligible for the investment credit.[5] Although the IRS was reversed in two of these cases, it was understood that the Service continued to adhere to the position that single purpose poultry-raising and egg-producing structures were not generally eligible for the investment credit.

Greenhouses are structures which provide an environment for the controlled growth of flowers and other plants. These structures also provide working space for persons who care for the flowers and plants within the greenhouse. It is the position of the Internal Revenue Service that greenhouses are buildings and consequently are ineligible for the credit. This position is based on the fact that these structures provide working space for persons tending the plants. The Service's position was sustained in two Tax Court cases decided in 1972.[6] However, the Tax Court was overruled in one of these cases on appeal.[7] In this latter case, the Ninth Circuit Court of Appeals found that the workers' activities in the greenhouse were "merely supportive of, and ancillary to" the principal use of the structure of providing an environment for controlled plant growth.

Reasons for change

When the investment tax credit was restored in the Revenue Act of 1971, the Congress intended to make it clear that the credit was to apply to single purpose agricultural structures. Despite this expression of intent, the Internal Revenue Service has continued a case-by-case approach with respect to application of the credit to single purpose agricultural structures and enclosures used for raising poultry, livestock, horticultural products or for producing eggs. Taxpayers' litigation to establish their right to these credits is both expensive and troublesome, particularly in cases involving small farmers with limited amounts of eligible property. As a result of this continuing controversy, the Congress decided to specifically provide that these agricultural structures are eligible for the investment credit.

Explanation of provision

This provision makes structures or enclosures used for single purpose livestock or plant production specifically eligible for the investment tax credit.[8] To be eligible for the credit under the Act, the structure must be both specially designed and used solely for the production of poultry, eggs, livestock, or plants. For example, if a portion of a greenhouse is used to sell plants (for example, by installation of a check-out stand for customers), the greenhouse will not qualify for the credit. However, the fact that a greenhouse provides working space for those who care for the plants will not make the greenhouse ineligible for the credit. A structure ceases to be a qualifying structure if it is used for a purpose (such as for storage of feed or equipment) which does not qualify it for the investment credit under this or other definitions of qualifying property. Mere vacancy of the structure will not violate the usage test, nor will the use of a minor portion of a structure for necessary post-productive activities which are ancillary to the raising of livestock or to the cultivation, production or harvesting of plants or plant products. Generally, such ancillary uses would include loading chutes and related facilities for livestock and sorting and packing areas for unprocessed plants and plant products. However, the use of structures or enclosures for processing activities, such as slaughtering or packaging meat, or marketing activities, such as displaying plants or other marketable products, would make them ineligible.

It is intended that this provision be broadly construed to apply to all types of single purpose structures and enclosures used to breed, raise and feed livestock and poultry (including the production of eggs and milk), and for the cultivation of plants. Thus, this provision will cover unitary hog, poultry, and cattle-raising systems, milking parlors, and commercial mushroom houses or greenhouses used to produce either plants or plant products.

If a single purpose structure becomes ineligible because of the usage test within seven years from the time it was placed in service, investment credits claimed on the structure may be partially or entirely recaptured under the investment credit recapture rules in present law. In addition, Congress wishes to emphasize that the specific provisions concerning the eligibility of these structures for the investment credit are not to create a negative inference regarding the eligibility of other single purpose agricultural and productive structures for the credit under existing law.

[4] S. Rept. No. 92-437 (92d Cong., 1st Sess. (1971)), 29-30.

[5] *Melvin Satrum*, 62 T.C. 413 (1974), nonacq., 1976-23 Int. Rev. Bull. 7 (June 7, 1976); *Starr Farms, Inc. v. U.S.*, 75-1 U.S.T.C. ¶9180 (W.D. Ark. 1975); *Walter Sheffield Poultry Co.*, T.C. Memo 1978-308.

[6] *Sunnyside Nurseries*, 59 T.C. 113 (1972); *Alve Thirup*, 59 T.C. 122 (1972).

[7] *Thirup et al. v. Comm.*, 508 F. 2d 915, 75-1 U.S.T.C. ¶9158 (9th Cir. 1974). This case was followed in *Sluppy, Inc. v. United States*, 78-2 U.S.T.C. ¶9604 (W.D. Mo. 1978).

[8] This provision was added to the Revenue Act of 1978 by a Senate Finance Committee amendment. A similar provision was the subject of a separate bill, H.R. 12846, which was reported by the House Ways and Means Committee (H. Rept. No. 95-1761, October 11, 1978), and was passed by the House on October 13, 1978.

The amendment is not intended to apply to general purpose agricultural structures, such as barns and other farm structures, which can be adapted to a variety of uses.

In addition, the Senate Finance Committee report stated that tangible personal property already eligible for the investment tax credit includes special lighting (including lighting to illuminate the exterior of a building or store, but not lighting to illuminate parking areas), false balconies, and other exterior ornamentation that have no more than an incidental relationship to the operation or maintenance of a building, and identity symbols that identify or relate to a particular retail establishment or restaurant such as special materials attached to the exterior or interior of a building or store and signs (other than billboards). Similarly, the Senate Finance Committee report stated that property eligible for the investment tax credit under prior law included floor coverings which are not an integral part of the floor itself, such as floor tile generally installed in a manner to be readily removed (that is it is not cemented, mudded, or otherwise permanently affixed to the building floor but, instead, has adhesives applied which are designed to ease its removal), carpeting, wall panel inserts such as those designed to contain condiments or to serve as a framing for pictures of the products of a retail establishment, beverage bars, ornamental fixtures (such as coats-of-arms), artifacts (if depreciable), booths for seating, movable and removable partitions, and large and small pictures of scenery, persons, and the like which are attached to walls or suspended from the ceiling.

Effective date

This provision is effective for open taxable years which end on or after August 15, 1971.

Revenue effect

This provision will reduce budget receipts by $53 million in fiscal year 1979, $33 million in fiscal year 1980, and $26 million in fiscal year 1983; the estimates for fiscal years 1979 and 1980 include the effects of reductions in liabilities from previous years.

5. Investment Credit for Certain Rehabilitated Structures (sec. 315 of the Act and sec. 48 of the Code)

Prior law

Property eligible for the investment tax credit has included tangible personal property (such as machinery and equipment) which is used in a trade or business or for the production of income. The investment credit has been allowed for other tangible property which is used in manufacturing, production, extraction, or as an integral part of furnishing transportation, communications, or electrical, gas, or other utility services, even though such tangible property may otherwise be considered real (and not personal) property under local law. Buildings and their structural components have not been eligible for the credit nor have expenditures for the purpose of rehabilitating or renovating existing buildings or structures.

Reasons for change

Buildings and their structural components have not been eligible for the investment tax credit since it was enacted in 1962. At that time, the Congress was primarily concerned about the substantially greater average age and lower efficiency of machinery and equipment in domestic manufacturing facilities in comparison with the facilities of major foreign producers of the same products.

Presently, there is a similar concern about the declining usefulness of existing, older buildings throughout the country, primarily in central cities and older neighborhoods of all communities. This situation, in part, reflects basic demographic and economic trends. It also is a response to changing architectural and engineering designs of buildings and the internal placement and flow of activities in manufacturing and commercial enterprise.

The Congress believed that it was appropriate now to extend the initial policy objective of the investment credit to enable business to rehabilitate and modernize existing structures. This change in the investment credit should promote greater stability in the economic vitality of areas that have been deteriorating.

Explanation of provisions

Qualifying expenditures

The Act extends the investment credit to rehabilitation expenditures incurred in connection with existing buildings used in all types of business or productive activities except those, such as apartments, which are used for residential purposes. Eligible buildings include factories, warehouses, office buildings, hotels[1] and retail and wholesale stores. The type of eligible building is to be determined on the basis of its use when placed in service after the rehabilitation, e.g., an apartment building rehabilitated for use as an office building would be treated as an eligible office building.

In order to qualify as a rehabilitation expenditure, the expenditure must be incurred after October 31, 1978, in connection with the reha-

[1] Buildings used for lodging generally will not be eligible (sec. 48(a)(3)). However, the exception for lodging facilities would not apply to rehabilitation of hotels and motels where the predominant portion of the accommodations is used by transients and section 48(a)(3), by its terms, does not apply.

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bilitation or reconstruction of a building which has been in use for a period of at least 20 years before the commencement of the rehabilitation. For this purpose, the determination of the 20-year period would be unaffected by periods during which a building was vacant or devoted to a personal use. In addition, the 20 year test is to be applied to the building without regard to the number of owners. The running of the 20-year period would commence at the earlier of the time depreciation deductions were first allowable with respect to the building or when it was first placed in use for any purpose (Treas. Reg. sec. 1.46-4(d)).

A rehabilitation of a building, or a major portion thereof, which had previously been rehabilitated would not be eligible for the credit until 20 years after the building was placed in service following completion of a prior rehabilitation for which a credit was allowed. (However, this latter limitation should not be interpreted to require continuous rehabilitation activity and preclude allowing the credit where there are delays between phases of a rehabilitation plan.) In addition, in order to exclude minor repairs or improvements, the costs must be of the type which must be capitalized under existing law (and not expensed) and must be incurred for property which has a useful life of at least five years.

In situations where a part of a building is rehabilitated, the rehabilitation costs will qualify for the credit only if the rehabilitated part constitutes a "major portion" of the building. In determining whether a part of a building constitutes a major portion, such factors as volume, floor space, and functional differences between the rehabilitated and unrehabilitated parts of the building should be taken into consideration. For example, where a substantial part of a building is used for commercial activities (such as retail stores) and another part is used for warehousing, each part will usually constitute a major portion of the building for purposes of these provisions. In addition, a rehabilitation of leased premises by either the lessor or the lessee, of the entire leasehold interest of a major portion of a building will be considered an eligible rehabilitation.

Under these rules and existing law, qualifying expenditures will be eligible for a two-thirds investment credit if the improvements attributable to the expenditures have a useful life of five or six years and a full credit where the useful life is seven years or more. Useful life for this purpose is the useful life used by the taxpayer for depreciation purposes. In addition, the existing rules concerning the recapture of investment credits will apply so that, if the property is disposed of or ceases to be qualifying property before the end of the appropriate useful life for which the credit was allowed, all or part of the credit will be recaptured.

Qualified rehabilitation costs will be considered as incurred for new property and, therefore, not subject to the $100,000 used property limitation, except to the extent such costs are for property (such as used elevators) which otherwise qualify for the investment credit. In these latter cases, the costs will not be considered as rehabilitation expenditures.

For purposes of this provision, the rehabilitation of a building will include the renovation, restoration, and reconstruction of an existing building. Thus, interior or exterior renovation or restoration to materially extend the useful life of the building, to significantly upgrade its usefulness, or to preserve it will normally qualify. Capital expenditures for the replacement of plumbing, electrical wiring, flooring, permanent interior partitions and walls, and the heating or air conditioning systems (including temperature control systems) would qualify as qualified rehabilitation expenditures when incurred in connection with a rehabilitation.[9] In addition, expenditures for the removal of existing interior walls, plumbing, electrical wiring, flooring, etc., would qualify if the expenditures were incurred in connection with the rehabilitation of a building and treated as capital expenditures for property with a useful life of at least 5 years.

If a rehabilitation is undertaken by a lessee, the lessee is eligible for the investment credit for qualified rehabilitation costs incurred by him, to the extent these costs are required to be capitalized by him and are not treated under other provisions of the law as payments in lieu of rent. Costs for which a lessee is entitled to reimbursement from the lessor would be taken into account for credit purposes by the lessor rather than the lessee. In determining qualified investment by a lessee, the useful life of a lessee's rehabilitation costs will be the useful life allowed to the lessee for purposes of depreciation or amortization of these costs under Code sections 167 and 178.

In the case of a rehabilitation by a lessor, the investment credit may be flowed through to a lessee under regulations prescribed by the Secretary of the Treasury under code section 48(d).

Nonqualifying expenditures

The costs of acquiring a building or an interest in a building (such as a leasehold interest) will not be considered as qualifying expenditures nor will costs that are incurred in connection with facilities, such as parking lots, which are related to an existing building. In addition, construction costs for a new building, or for completing a new building after it has been placed in service, will not qualify.

Limitations are also provided to exclude costs incurred for new construction or enlargement of an existing building. In the case of an enlargement, costs will not be considered qualifying expenditures to the extent incurred to expand the total volume of the existing building. However, an increase in floor space resulting from interior remodeling will not be considered an enlargement. In addition, construction costs will be considered for new construction rather than for the rehabilitation of a building if more than 25 percent of the existing external walls of the building are replaced. This latter restriction, however, is not intended to be interpreted to cover situations where existing walls are covered (e.g., the outer walls are covered by new siding in connection with the rehabilitation) or reinforced.

Certified historic structures

In the case where expenditures are eligible for 5-year rapid amortization as rehabilitation expenditures for a certified historic structure, a taxpayer must choose between the benefits of 5-year rapid amortization for the rehabilitation expenditures or the investment tax credit on the expenditures. If rapid amortization is chosen, the expenditures will not be eligible for the investment tax credit. In addition, rehabilitation expenditures in connection with a certified historic structure must themselves be certified as appropriate by the Secretary of the Interior in order to qualify for the investment credit in those situations where the taxpayer elects to claim the credit rather than 5-year amortization.

Effective date

These amendments are effective for taxable years ending after October 31, 1978, with respect to qualifying rehabilitation expenditures incurred after that date. The amendment relating to rehabilitated certified historic structures applies to property placed in service after October 31, 1978.

Revenue effect

This provision will reduce budget receipts by $67 million in fiscal year 1979, $181 million in 1980, and $236 million in fiscal year 1983.

6. Investment Credit for Cooperatives (sec. 316 of the Act and sec. 46 of the Code)

Prior law

Under present law, cooperatives are taxed as corporations. However, unlike regular corporations, cooperatives are allowed to deduct certain payments and allocations made to patrons and shareholders (sec. 1382 (b) and (c)). Patrons are those persons with whom, or for whom, the cooperative does business on a cooperative basis. With certain exceptions, the patrons include the deductible payments and allocations in their taxable income (sec. 1385).

Because of this special treatment, the amount of otherwise allowable investment credit which could have been used by a cooperative was limited under prior law by a fraction, the numerator of which was the cooperative's taxable income and the denominator of which was the cooperative's taxable income plus the deductible payments made to patrons and shareholders (sec. 46(e)(3)(C)). The portion not allowed to the cooperative was not passed through the patrons.

Reasons for change

Cooperatives play a significant role in the American economy, particularly in the agricultural sector. The capital needs of cooperatives to finance expansion and modernization, coupled with the reduced level of investment credit available to these taxpayers, both hinders their growth and reduces the amount of patronage distributions which flow through to patrons. In light of these considerations and because the reductions in the corporate income tax rates (also provided in the Act) are of relatively limited benefit to cooperatives, the Congress decided to liberalize the investment credit as it applies to cooperatives.

Explanation of provisions

The Act allows cooperatives, including farmer's cooperatives and other similar cooperative organizations (as defined in Code section 1381(a)), to claim the investment credit to the same extent it is available for taxpayers in general. The credit would not be reduced to reflect the deduction for patronage dividends, as under prior law.

The investment credit earned by the cooperative for a taxable year will be applied to reduce the cooperative's tax liability for that taxable year. To the extent the cooperative cannot use an investment credit in the current year, the credit will not be carried back or carried forward but will be allocated to the patrons of the cooperative. However, it is not intended that these new rules apply to carryover credits of the cooperative from years prior to the effective date of this provision. As a result, the cooperative must apply these carryover credits first to its current year tax liability, which may indirectly increase the amount of credits allocated to patrons for the current year. In addition, credits disallowed to cooperatives under section 46(e) for taxable years ending prior to the effective date are not revived and may not be carried over or passed through to the patrons.

The investment credit rules (sections 46-48) will generally be applied at the level of the cooperative. Thus, the determination of quali-

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[9] Under present law, it may be difficult to classify certain items as either tangible personal property which is eligible for the investment tax credit or as structural components of a building which are ineligible. To the extent attributable to a qualified rehabilitation, the classification problem for these items would be eliminated because they would be eligible for the credit under either

Historically Significant Buildings Where Space Has Been Leased by GSA

	Building and Address	City & State	Sq.Ft.	Lease Award Date	Remarks
	Union Station	New London, CT	1,500	5/10/78	Defense-Colocated Recruiting
*	One Dock Square	Boston, MA	4,800	8/7/79	OSHA. In historic district.
	24 Palmer Street	Lowell, MA	10,653	2/23/78	Defense-Recruiting, HEW/SSA
*	Thorndike Building 389 Main Street	Rockland, MA	2,717	10/4/79	SSA. In historic district. In CBA. Occupy 12/1/79.
*	Farm & Home Center 21 So. Grove Street	East Aurora, NY	1,968	1/25/75	Part of Raycroft campus. Listed in Nat'l. Register.
	Custom House 2243 Whirlpool St.	Niagara Falls, NY	450	3/25/70	Customs
	Schuyler County Courthouse	Watkins Glen, NY	1,500	6/6/78	U.S. Courts
	Curtis Building 625 Walnut Street	Philadelphia, PA	213,824	effective 7/1/69	HUD, EPA. Leased before Cooperati Use Act enacted.
	Fort Pitt Commons 445 Fort Pitt Blvd.	Pittsburgh, PA	33,810	1/12/79	HUD, GAO. In CBA.
	Old Customs House 8th & Broadway	Nashville, TN	6,000	7/22/77	Corps of Engineers
	Old Customs House 8th & Broadway	Nashville, TN	3,701	9/28/77	IRS (2,486 sq.ft.) Soil Conservatic Service (1,215 sq.ft.).
	1st Union National Bank 201 N. Front Street	Wilmington, NC	14,300	5/24/78	DOT, COE, Treasury

Building and Address	City & State	Sq.Ft.	Lease Award Date	Remarks
Marshland House Ft. Johnson Road	Charleston, SC	1,035	10/26/76	Department of Interior
*10 Elliot Street	Charleston, SC	2,000	7/30/79	Justice-Probation Office. In historic district.
Butler Square Building 100 North 6th Street	Minneapolis, MN	10,534	8/30/78	Labor needs additional 2,500 sq. ft. Justice wants 1,250 sq. ft. Both to be awarded 12/1/80. CBA fringe.
Atlas Building 10 E. Long	Columbus, OH	3,845	11/6/78	DOD-Colocated Recruiting moved in 12/5/78.
*Lincoln LaVeque Tower 50 W. Broad Street	Columbus, OH	7,027 2,700	8/1/77 9/26/79	HEW-SSA Hearings & Appeals HEW-Audit. Occupy by 10/31/79.
**Bayfield County Courthouse	Bayfield, WI	5,557	8/9/78	National Park Service will occupy 10/15/79. In CBA.
Castle Station Building 500 Federal Street	Saginaw, MI	1,836	6/29/77	USDA/AMS Grain Inspection
Aquila Court 1615 Howard	Omaha, NE	4,867	9/30/77	Food and Drug Administration, USMC. In CBA.
City National Bank 405 S. 16th	Omaha, NE	4,400	7/12/79	On Nat'l Reg. In CBA. Colocated Recruiting. Occupancy 9/1/79.
Scarritt Building 818 Grand	Kansas City, MO	15,990	8/10/78	Interior. ATF, Public Defender. In CBA.
Midland Building 1221 Baltimore	Kansas City, MO	6,250	5/23/78	Agriculture

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Building and Address	City & State	Sq.Ft.	Lease Award Date	Remarks
Professional Building 1103 Grand Avenue	Kansas City, MO	72,775	7/13/79	HUD. Occupy 1/1/80. In CBA Being nominated to Nat'l Reg.
Uptown Theatre 3710 Broadway	Kansas City, MO	925	6/19/79	Army Recruiting. Not in CBA. Being nominated to Nat'l. Reg.
S.E. Corner Building Bolivar & Main Streets	Jefferson City, MO	3,150	1/26/77	U.S. Army Corps of Engineers
First National Building 109 N. Oregon	El Paso, TX	16,862	11/17/78	AFEES. On Nat'l. Reg. In CBA.
**Neil P. Anderson 411 W. 7th Street	Ft. Worth, TX	13,228	11/30/77	Securities and Exchange Commission. In CBA. On Nat'l. Reg.
		4,621	6/27/79	GSA Audits & Investigation.
		17,847	7/24/79	ICC. Occupy by 10/25/79.
T&P Office Building 221 W. Lancaster	Ft. Worth, TX	67,800	4/13/79	DHUD. In CBA. On Nat'l. Reg. Occupancy by 11/1/79.
Boston Building 9 Exchange Place	Salt Lake City, UT	3,100	8/9/78	SEC
Crane Building	Salt Lake City, UT	4,772	3/5/79	Mine Safety & Health Admin. Nomination in process.
Alamo Building 128 S. Tejon	Colorado Springs, CO	9,100	1/4/78	Internal Revenue Service
Post Plaza Building 201 S. College	Ft. Collins, CO	4,960	9/29/78	Western Area Power Admin. Formerly U.S. Post Office.

Building and Address	City & State	Sq.Ft.	Lease Award Date	Remarks
Pine Street School	Redding, CA	507	9/15/78	Office of Personnel Mgmt.
The Arlington Victorian Row 492 9th Street	Oakland, CA	17,240	5/10/77	Lessor also developer of City Redevelopment area including this building. Renovation delayed pending city/developer/landowner negotiations. Tenants will be agencies from FB, schedule for closure due to inadequate earthquake protection design.
Idaho Building	Boise, ID	892	1/17/79	ACTION. In Capitol area Historic District.
Union Trust Annex 117 S. Main Street	Seattle, WA	5,500	5/27/77	National Park Service

*Projects added since last report
**Changes made since last report

STATEMENT ON BEHALF OF THE NATIONAL ASSOCIATION OF LIFE COMPANIES

This statement is submitted on behalf of the National Association of Life Companies (NALC). The NALC, whose principal office is in Atlanta, Georgia, was organized in 1955. Its over 300 life insurance company members are active in more than 40 States, Puerto Rico and Canada, represent more than 60 million policyholders, and have more than 400,000 shareholders and 170,000 employees.

THE PROBLEM IN BRIEF

The purpose of this statement is to call to your attention a problem inadvertently created by the Revenue Act of 1978's changes in the entertainment facility expense deduction rules of Internal Revenue Code section 274. Those changes potentially result in a "double disallowance" of deductions for entertainment facility expenditures associated with incentive award trips provided to independent contractors and other persons who are not employees. For example, revised § 274(a)(1)(B) might be applied to preclude a company's deduction of entertainment facility expenditures associated with an incentive award trip even though such expenditures were includable in the income of the non-employee recipient who was also allowed no offsetting deduction. Similarly, the new entertainment facility rules conceivably could be applied to produce a "double disallowance" of certain expenses incurred by a taxpayer in sponsoring a business convention for independent contractors or other non-employees. A technical explanation of the manner in which this potential problem arises is set forth in the Appendix attached hereto.

It seems clear that Congress, in enacting last year new rules for the deduction of entertainment facility expenses, did not intend to create a possible "double disallowance" of such deductions. Indeed, in addition to its revision of Code section 274(a)(1)(B)'s entertainment facility expense rules, the Revenue Act of 1978 also contained an amendment to the foreign convention rules of Code section 274(h) designed to prevent a similar "double disallowance" result where foreign convention expenses are includable in the income of a person attending the convention. Plainly Congress did not intend to solve the foreign convention "double disallowance" problem and at the same time create a "double disallowance" of entertainment facility expenditures potentially affecting both foreign and domestic conventions.

POSSIBLE SOLUTIONS

The most straightforward solution to the entertainment facility expense "double disallowance" problem would be to include in Internal Revenue Code section 274(e)'s exceptions from section 274(a) a new exception for amounts which are includable in the income of an independent contractor or other person who is not an employee of the person making such expenditures. Such a provision would restore the treatment of expenditures for incentive award trips and similar items prevailing prior to the Revenue Act of 1978. Alternatively, in drafting such a new exception, Congress might reasonably take the approach employed last year in section 274(h)(6)(D)(ii). This provision dealt with a similar problem under the foreign convention rules by excepting from disallowance under those rules amounts includable in the income of another person, subject to a restriction that if an amount is required to be included in an information return under the generally applicable information return requirements, it must be so included in order for the exception to apply. Certaintly, there is no reason, particularly in a technical corrections act, to go beyond this approach and impose information return restrictions more stringent than those of section 274(h)(6)(D)(ii). Doing so would simply create a trap for taxpayers relying on that section and the normal information return reporting rules of Code section 6041.

In any event, the addition of a new exception to deal with the entertainment facility expense "double disallowance" problem should be included in the Technical Corrections Act of 1979. Absent such an amendment, insurance companies and other taxpayers operating through non-employee sales forces will be without guidance as to how, if at all, they can be assured of the deductibility of legitimate business expenses incurred in sponsoring both incentive award trips and business conventions for their sales personnel.

STATEMENT ON BEHALF OF THE NATIONAL ASSOCIATION OF LIFE COMPANIES: APPENDIX—TECHNICAL EXPLANATION

Prior to the changes made by the Revenue Act of 1978, section 274(a)(1)(B) provided an exception from the otherwise applicable disallowance of entertainment facility expense deductions if "the taxpayer establishe[d] that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such trade or business." The Regulations, specifically Reg. § 1.274-2(c)(5), in turn provided that an expenditure "made directly or indirectly by the taxpayer for the benefit of an individual (other than an employee)" which was "in the nature of compensation for services rendered" or which was a "prize or award" required to be included in the recipient's gross income under Internal Revenue Code section 74 would be treated as "directly related" to the taxpayer's trade or business.

By virtue of these provisions of the Code and Regulations, taxpayers were assured of the deductibility of those expenses, such as lodging, which might be deemed entertainment facility expenditures associated with incentive award trips and similar activities. If the expenditure was includable in the income of an independent contractor (or other non-employee) recipient, it was deductible by the payor taxpayer even though it might constitute an entertainment facility expenditure which would otherwise have been disallowed.

The Revenue Act of 1978, however, eliminated from Code section 274(a)(1)(B) the statutory exception through which the Regulations operated to provide a correlative deduction where entertainment facility expenditures were includable in the income of a non-employee beneficiary of the entertainment facility ependitures. The unintended effect of this change may best be illustrated by an example. Company T awards to independent contractor or dealer A an expense paid vacation trip as a result of A's successful efforts in selling T's products. In this case, the value of the trip is clearly includable in A's income. Under Reg. § 1.274-2(c)(5), the expenditures made by T for the trip are treated as "directly related" to the active conduct of T's trade or business. Because they are "directly related," the entertainment activity expenditures associated with the trip are deductible by T by virtue of the provisions of Code section 274(a)(1)(A). The cost of lodging and certain other expenses paid by T in connection with the trip may properly be classifiable as entertainment facility expenditures however, which are governed bythe revised entertainment facility rules of Code section 274(a)(1)(B). Since Code section 274(a)(1)(B), as revised by the Revenue Act of 1978, contains no exception from disallowance for "directly related" entertainment facility expenditures, even where such expenditures are primarily in furtherance of the payor's trade or business, T might not be allowed to deduct these facility expenditures. (The Code section 274(e)(3) exception for "expenses treated as compensation" would not be available because A is not an employee.) The facility expenditures would be included in A's income, however, and A would not be allowed an offsetting deduction for them. The net result, therefore, is a "double disallowance" of the entertainment facility expenses incurred by T.

While the "double disallowance" of entertainment facility expenses is most clearly illustrated by the pure incentive award trip example, the potential problem also arises in other contexts. Business conventions often involve functions which might be deemed entertainment. It is conceivable that the Internal Revenue Service might, under the Revenue Act of 1978's revision of section 274(a)(1)(B), seek to disallow deduction of the entertainment facility expenditures associated with such functions even though such expenditures are properly includable in a non-employee recipient's income. A similar problem might arise with respect to the expenses associated with attendance by the spouse of an independent contractor (or other non-employee) at a business convention. In circumstances where the spouse's attendance is not sufficiently business related, it is conceivable that the IRS might seek to disallow a deduction for lodging or other "entertainment facility" expenses to the taxpayer paying the spouse's expenses, even though such expenses would simultaneously be included in the income of the independent contractor.

In order to avoid the possible "double disallowance" of entertainment facility expense deductions resulting from the Revenue Act of 1978, Code section 274(e) should be amended so as to clearly provide a correlative deduction to payors where such expenditures are includable in the income of nonemployee recipients of the entertainment (or in the income of the spouses or other relatives of such recipients). A provision of this type, without further restrictions, would restore the status quo as it existed prior to the Revenue Act of 1978 with respect to entertainment facility expenses. An alternative to simple restoration of the status quo prior to the Revenue Act of 1978 would be to extend the more restrictive approach embodied in Code section 274(h)(6)(D)(ii), which was adopted as part of the Revenue Act of 1978 in

order to deal with potential "double disallowance" under the foreign convention rules, to the entertainment facility context. Under this approach, a new Code section 274(e) exception would be added providing a deduction for entertainment facility expenditures by payors if such expenditures are includable in a non-employee's income and the payor includes such expenditures on an information return, if such a return is required under the generally applicable information reporting requirements of the Code.

NOVEMBER 7, 1979.

HON. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: In response to your press release dated October 16, 1979. soliciting written statements and comments on the Technical Corrections Act of 1979, the following comments are hereby submitted by Business Incentives, Inc., E. F. McDonald Travel Company, International Travel Associates, Inc., Maritz, Inc., Premium Corporation of America, S&H Motivation and Travel, Inc., and Top Value Enterprises.

SUMMARY

Section 274 of the Internal Revenue Code should be amended to insure that the language of section 274(a)(1)(B), which was added by the Revenue Act of 1978, is not misinterpreted to conflict with section 274(h)(6)(D)(ii) and disallow the deduction, by an incentive program sponsor, of expenses for incentive travel awards which are includible in the gross income of the award recipients. For example, a dealer who exceeds a sponsoring manufacturer's sales objective may earn a trip award which will then be includible in the dealer's gross income under section 274 of the Internal Revenue Code. The Technical Corrections Act should clarify that the expenses of such incentive awards are deductible by the manufacturer, without changing any rules of section 274 which would deny deductibility by the award recipient. This would be a strictly technical change to conform the language of section 274(a)(1) to Congressional intent as expressed in the Report of the Senate Finance Committee on the Revenue Act of 1978.

ANALYSIS

Section 274(a)(1) was amended by section 361(a) of the Revenue Act of 1978 in order to limit the deduction allowed with respect to entertainment facilities. As explained in the Report of the Senate Finance Committee,

"Generally, the term 'facility' includes any item of real or personal property which is owned, rented, or used by a taxpayer in conjunction or connection with an entertainment activity. Thus, expenses incurred with regard to entertainment facilities which are disallowed, include yachts, hunting lodges, fishing camps, swimming pools, tennis courts, and bowling alleys. Facilities also may include airplanes, automobiles, hotel suites, apartments and houses (such as beach cottages and ski lodges) located in recreational areas. However, the deduction is not affected unless the property is used in connection with entertainment." S. Rep. No. 95-1263 at 174-75.

The Senate Finance Committee Report expressly states that the facilities amendment was not intended to change the rules applicable to overnight business travel or conventions. As stated in the Committee Report,

"[T]he bill generally would not apply to expenses incurred by an individual away from home at a bona fide business, trade, or professional organization meeting or convention. These expenses, however, would continue to be subject to the generally applicable rules relating to the deductibility of business travel, convention, and entertainment activity expenses." *Id.* at 175.

In addition to the above described amendment concerning entertainment facilities, the Revenue Act of 1978 also specified that the restrictions on the deductibility of foreign convention expenses should not cause a double disallowance of such expenses under circumstances where the cost of an incentive travel award was paid by one person as a business expense and includible in the income of another person. As explained in the Report of the Senate Finance Committee,

"For example, where a manufacturer purchases tickets for the attendance by one or more of the employees of its dealers at a foreign convention as an incentive award and transfers the tickets to its dealers who in turn award them to certain employees, the manufacturer will not be subject to these limitations [on deductibility] if the tickets are includible in income of the dealer and the manufacturer complied with any required information reporting. Further, the limitations will not apply to the dealer for any amount if the employee is required to include that

amount in his income and the dealer complies with the applicable information reporting requirements. Of course, the rules described above limiting deductions for foreign conventions continue to apply to the individual involved to determine the extent to which he is entitled to deduct the convention expenses." S. Rep. No. 95-745 at 18-19.

Under section 274(a)(1) as amended by the Revenue Act of 1978, it appears that expenses for an incentive travel award (foreign or domestic) may be considered nondeductible by the payor, even though the value of the award is includible in the income of the recipient and is properly reported on any required information return. A technical amendment is therefore necessary to resolve any inconsistency between the amendment to section 274(a)(1) and the amendment to section 274(h), both of which were included in the Revenue Act of 1978. This problem was discussed in a recent article in the Journal of Taxation as follows:

"Under the definition of entertainment contained in Reg. 1.274-2(b)(I)(i), an incentive award trip of this sort would appear to constitute 'entertainment.' If this is correct, then expenditures incurred for lodging and perhaps transportation and some other items in connection with the trip would appear to constitute expenditures with respect to an entertainment *facility* under Regs. 1.274-(e) (2) and (3). Absent an applicable exception, these facility expenditures may be disallowed by new section 274(a)(1)(B), although they rather clearly were not disallowed under its prior version and even though they constitute income to the customer or independent contractor recipient for which no offsetting deduction to the recipient is allowed." Bostick & Terr, How the 1978 Act Affects T&E Deductions for Facilities: Implications and Planning, 50 J. Taxation 130 at 134.

This article characterizes the above problem as an "unintended result" and notes that the potential disallowance of deductions for incentive award trips would be a result "which Congress clearly did not have in mind" when amending section 274(a)(1). *Id.* at 133. For this reason, adoption of an amendment to deal with this problem would be a strictly technical change designed to conform the language of the 1978 Act to the Congressional intention as expressed in the Finance Committee's Report.

In cases where incentive travel awards are made by companies to their agents or dealers, the awarding manufacturer or other sponsor has merely used a method of marketing promotion which is based on the premise that its salemen or dealers will put forth greater effort to excel if they are presented with the incentive of earning a trip. Alternatively, the sponsor could award cash or merchandise prizes to those earning the trip and there would be no question concerning the deductibility of the prizes by the sponsor.

Any potential abuse of the type which gave rise to the provisions restricting the deductibility of entertainment facilities would involve the recipient of a travel award who is required by section 74 of the Code to include the value of the trip in his income. The recipient could not normally deduct any amount with respect to the trip under the limitations set forth in section 274 of the Code. Thus, the purposes of section 274 are completely carried out at the level of the trip recipient without limiting the sponsor's deduction. Indeed, if section 274(a)(1) should be misconstrued to apply to incentive travel awards, it would not only be flatly inconsistent with the amendment to section 274(h) adopted to deal with this very problem as part of the Revenue Act of 1978, but would also have the anomolous result of imposing a double tax on such awards—once at the sponsor's level and a second time at the level of the award recipient.

The uncertainty concerning the application of the broad language of section 274(a)(1)(B) has created a deterrent to incentive programs involving travel awards. This uncertainty has an adverse effect on the undersigned companies which are significantly engaged in the business of conducting, for sponsoring companies, incentive programs which offer travel and merchandise awards to persons who attain high levels of achievement.

Accordingly, it is requested that the Technical Corrections Act of 1979 preclude this obviously unintended interpretation of the Revenue Act of 1978. This can be accomplished by amending section 274(e)(3) to add language corresponding to the language already added under section 274(h)(6)(B)(ii) with respect to foreign conventions. Such an amendment would make it clear that a deduction is not disallowed to any sponsor who is not the individual who is the recipient of a trip award, if the value of the trip award furnished by the sponsor is includible in the income of the recipient, and if applicable information reporting rules are compiled with. The restrictions on the deductibility of entertainment activities and facilities would of course remain applicable to the recipient of a trip award as well as to any person

who pays for the expenses of a travel award under circumstances where the recipient is not required to include such expenses in his gross income.

Respectfully submitted,

William M. Shumate, Vice President, Travel Business Incentives, Inc.; J. E. Trabert, President, International Travel Associates, Inc.; John Heim, Vice President and General Counsel, Premium Corporation of America; James B. Goodman, Director, Administration, E. F. MacDonald Travel Co.; Henry S. Stolar, Vice President and Associate General Counsel, Maritz, Inc.; John J. Reisdorf, Vice President, Treasurer/Controller, S&H Motivation and Travel, Inc.; H. E. Lambert, General Attorney, Top Value Enterprises.

Summary of the Statement of James F. Fitzpatrick, on Behalf of the Estate of Sigmund Sommer

The purpose of the following statement is to urge that there be an amendment to the Technical Corrections Act of 1979 to provide that where an individual is an "original seller" of cooperative housing corporation property and such individual dies, his estate will be deemed to be the "original seller" for a three-year period following his death. The statement may be summarized as follows:

1. Section 216 of the Internal Revenue Code permits deductions of mortgage interest and property taxes to be passed-through to tenant-stockholders of a cooperative housing corporation where the cooperative receives 80 percent or more of its gross income from individual tenant-stockholders.
2. In order to encourage cooperative housing development, Congress has recognized that cooperative housing projects involve a start-up period after incorporation during which time units that were not sold prior to incorporation are held out for sale. The stock representing these units is held by the promoter ("original seller") of the cooperative. The Revenue Act of 1978 permits promoters other than individuals, (*e.g.* corporations, estates, etc.) to be treated as individual tenant-stockholders for the three-year period following incorporation of the cooperative. The effect of this provision is to permit the corporation to meet the 80 percent gross income test during the start-up period so that individuals who had already purchased units in the cooperative are entitiled to their ratable deductions.
3. In order to qualify for this three-year grace period under the 1978 Act, the promoter must be the person who transferred the actual property to the cooperative housing corporation at incorporation.
4. The Revenue Act of 1978 fails to address the situation where an individual promoter dies after transferring the property to the corporation but prior to selling all of stock representing the units to be sold. When such an individual's estate succeeds to the unsold stock in a cooperative, we believe the estate should be entitled to be treated as a tenant-stockholder.
5. An amendment to correct the situtation is truly a technical amendment. It would not alter substantive tax policy and, indeed, helps satisfy the objectives Congress had in mind in 1978. We believe the failure to address this situation in 1978 was clearly inadvertent.

Summary of the Statement of James F. Fitzpatrick, on Behalf of the Estate of Sigmund Sommer

Good afternoon, I am James F. Fitzpatrick of the law firm of Arnold & Porter, Washington, D.C. I am appearing today on behalf of the Estate of Sigmund Sommer. At the time of his death earlier this year, the late Mr. Sommer was the promoter of a New York City coopertive apartment building that qualified as a cooperative housing corporation under Section 216 of the Internal Revenue Code.

The purpose of my testimony is to explain to you a technical problem arising under the Revenue Act of 1978's amendments to the Internal Revenue Code provisions regarding cooperatives.

Under the Internal Revenue Code, individual tenant-stockholders of qualified cooperatives are treated as direct owners of real property in the sense that the cooperative's expenditures for real estate taxes and mortgage interests are passed through to the tenant-stockholders on a proportionate basis. The individual tenant-stockholders are then entitled to deductions in respect of these expenses on the same basis as owners of individual single-family dwelling units. In order for a cooperative to qualify for this pass-through, it must derive at least 80 percent of its gross income from individuals who are tenant-stockholders. If gross income from

tenant-stockholders falls below this 80 percent mark, individual tenant-stockholders lose their deductions for mortgage interest and real property taxes paid.

It has always been the case under the Internal Revenue Code provisions regarding cooperatives that an individual who is a promoter of a cooperative will have his payments for cooperative expenses regarded as receipts from a tenant-stockholder. The Revenue Act of 1978 (Section 531), amended the Internal Revenue Code to permit promoters of cooperatives other than individuals (e.g. corporations, estates, etc.) to be deemed tenant-stockholders for a three-year period after the cooperative is incorporated and the promoter takes back stock representing unsold units. The purpose of the 1978 law is to permit all promoters of cooperatives a grace period in which to sell the dwelling units in the cooperative and, at the same time, to permit the owners of the first dwelling units sold to claim tax and the interest deductions during this start-up period until 80 percent of the project is sold to individual tenant-stockholders.

In order to qualify as a promoter who will be deemed a tenant-stockholder, the promoter must be the "original seller" of the cooperative property. This means that the promoter must be the person who transferred the property to the cooperative housing corporation at incorporation.

Our client's situation seems to fall in an unintended crack in the 1978 legislation. Mr. Sommer transferred an apartment building to a cooperative housing corporation shortly before his death. As is the usual case with cooperatives, at the time of such transfer, a substantial number of apartment units remainded unsold and Mr. Sommer took back the stock representing these unsold units with a view toward selling them. Very shortly thereafter, Mr. Sommer died and his estate succeed to the stock which he held in the cooperative. Technically, although estates can qualify as promoters under the 1978 legislation, it is possible that some might argue that this particular estate would not so qualify since the estate was not the person who actually transferred the property to the corporation. Had Mr. Sommer died a month or two earlier, prior to the transfer of the building to the cooperative and had his estate been the person who transferred the building at incorporation, there is no question that the estate would be entitled to be deemed a tenant-stockholder under the 1978 Act.

Mr. Sommer's untimely death shortly after the date of incorporation, would not appear to be covered expressly by the statute and it is possible that the estate's ownership of Mr. Sommer's stock and its payment of ratable expenses could cause the cooperative to fail the 80 percent gross income test with the result that both the estate and the significant number existing owner occupiers who have already bought units would lose substantial tax deductions for mortgage interest and property tax.

Because the purpose of the 1978 Act was to benefit the initial tenant-stockholders who purchase and occupy units of a cooperative while the promoter (be it an individual, corporation, estate) sells the remaining units during a given grace period, we believe the Act should be clarified to assure that this purpose is fully accomplished.

In the absence of such a clarifying technical amendment the tax liabilities of many persons the promoter as well as the individual unit owners of the first units sold) could turn on fortuitous events, such as the death of an individual promoter, which have no significance in terms of such tax liabilities. Furthermore, the express Congressional policy of encouraging cooperative housing development by providing promoters with a grace period could be substantially thwarted in the absence of a technical amendment to take care of an individual promoter's death.

Accordingly, we believe an amendment to the Technical Corrections Act is in order. We would suggest that the present definition of "original seller" in Section 216 of the Internal Revenue Code be amended by the act with the addition of language along the following lines:

"Where an individual who is an original seller dies, the estate of such individual shall be treated as the original seller and shall be deemed to have acquired the stock fo the corporation as of such individual's date of death in the same manner in which such individual had acquired such stock."

The effect of this language is to provide the estate of an original seller with a full three years in which to dispose of unsold units. It is appropriate to start the running of this three-year period with the death of the promoter rather than with the date of incorporation of the cooperative because an individual tenant-stockholder indefinitely and without regard to the 1978 amendments. Accordingly, a promoter in Mr. Sommer's position, would have anticipated an indefinite time period in which to dispose of the cooperative stock. At his death, it is appropriate to provide his estate with the same period of time in which to dispose of such stock as

any entity would have upon its receipt of stock in a cooperative. Since we believe the amendment we propose today merely clarifies Congress' intent in enacting the Revenue Act of 1978, the effective date of this amendment should relate back to the effective date of the cooperative provisions in the 1978 Act.[1]

We believe the problem which we have raised today could be solved by other language as well and, we are willing to work with the staff to develop alternative language if this Subcommittee believes this would be an appropriate course of action.

Thank you very much for the opportunity to bring this problem to light today and I would be happy to answer any questions you may have.

Statement of the National Cattlemen's Association

Mr. Chairman, my name is Thomas A. Davis and I am appearing before you today as Washington tax counsel for the National Cattlemen's Association. The National Cattlemen's Association is the national spokesman for all segments of the nation's beef cattle industry—including cattle breeders, producers and feeders. The NCA represents approximately 280,000 professional cattlemen throughout the country. Membership includes individual members as well as 51 affiliated state cattle associations and 15 affiliated national breed organizations.

First let me say the NCA endorses generally the provisions in the Technical Corrections Act, particularly those changes correcting provisions of direct interest to farmers and ranchers. The specific comments today are directed to a technical change which is not in the bill but which NCA believes should be included.

In the Tax Reform Act of 1976, Congress enacted a provision which allows farm land to be valued for federal estate tax purposes on the basis of the agricultural use of the land. This special use valuation provision (Section 2032A of the Internal Revenue Code) contains a rental value formula for determining the value of agricultural land.

The rental valuation formula provides that the value of a qualified farm or ranch can be determined by dividing "(i) the excess of the average annual gross cash rental for comparable and used for farming purposes and located in the locality of such farm over the average annual State and local real estate taxes for such comparable land, by (ii) the average effective interest rate for all new Federal Land Bank loans." Each average annual computation is made on the basis of the five most recent calendar years ending before the farmer's or rancher's death.

In applying the rental valuation formula, the IRS issued proposed regulations in July of 1978 which provided that crop shares could be converted into cash equivalents for purposes of the rental valuation formula. However, on September 10, 1979, the IRS reversed its position and issued revised proposed regulations which state that only "cash" rentals can be used for purposes of the valuation formula. The result—the rental valuation formula cannot be used unless comparable farm land can be located on which there are cash rental. Otherwise, the land can only be valued under the five-factor formula provided by Section 203A(e)(8).

The effect of the revised proposed regulations by the Internal revenue Service will be to deny the use of the rental valuation formula to numerous estates of farmers or ranchers who live in areas where cash rentals are not used.

In the Committee Report of the House of Representatives regarding the Tax Reform Act of 1976 (on pages 24 and 25), it was stated that the reasons for providing the valuation formula were: (1) to reduce subjectivity and controversy; (2) to eliminate values which might be attributable to the potential for conversion to nonagricultural use, and (3) to abolish "as a valuation factor any amount by which the land is bid up by speculators in situations where nonagricultural use is not a factor in the inflated farm land values." Consequently, it was clear that Congress intended that the rental value formula be available for valuation of farms and ranches which qualify for agricultural use valuation. Yet, the interpretation given by the Internal Revenue Service will prevent use of the rental value formula in many situations where it appears Congress clearly intended the formula should be available.

For the reasons previously expressed, the National Cattlemen's Association proposes that the special valuation provision be amended to make it clear that "crop share or other similar non-cash rental arrangements" can be used in the rental valuation formula. The thrust and purpose of this proposal is to make the rental valuation formula available to all qualified farm and ranch land by computing the

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[1] The effective date was of enactment. Absent a retroactive perfecting amendment of this kind, it is con ceivable that the many persons affected by a cooperative's tax status would have the availability of their tax deduc tions turn on whether an individual promoter had died the day before or the day after incorporation.

special use valuation based on the agricultural production capacity of such land measured by the rental value of such land, whether determined by cash rentals or the conversion into cash of any "in-kind" rentals, including crop shares.

NCA further proposes that the rental valuation formula be amended to delete the "comparable land" standard and to substitute instead a provision that the valuation formula would apply to the rental value of the qualified farm or ranch land being valued. This would mean that the appraisers would value the qualified farm or ranch land on the amount of gross rental it would produce, based on its actual farming or ranching use, measured on an arm's length basis and determined on a cash, crop share or other in-kind basis. For example, if the qualified farm land had been used for growing wheat, the rental value of such land for purposes of the valuation formula would be based on the amount of gross rental (whether cash, crop shares, or other "in-kind" amount converted to cash amounts) which such land would produce if rented on an arm's length basis for growing wheat during the relevant valuation period.

Deleting the "comparable land" requirement, avoids the problem of denial of the rental valuation formula where the Internal Revenue Service asserts that there is no comparable land in the locality.

It should also be noted that S. 1859, introduced by Senators Percy and Dole, would allow crop share rental to be used in the rental valuation formula if there is no comparable land from which the average annual gross rental may be determined but there is comparable land from which the average net share rental may be determined. We endorse the general purpose of this bill to allow crop share rental to be taken into account in the rental valuation formula. The NCA proposal goes one step further and eliminates the "comparable land" requirement.

A copy of the statutory language to implement the changes proposed by NCA is attached to this statement.

Thank you for this opportunity to present the views of the nation's beef cattle industry.

A BILL

Be it enacted by the Senate and House of Representatives of the United States in Congress assembled.

Paragraph (7) of Section 2032A(e) of the Internal Revenue Code of 1954 is amended to read as follows:

"(7) METHOD OF VALUING FARMS—

(A) *In general.*—Unless the executor elects to have the value of the farm for farming purposes determined under paragraph (8), the value of a farm for farming purposes shall be determined by dividing—

(i) the excess of the amount of the average annual gross rental value of the qualified real property used for farming purposes over the amount of the average annual State and local real estate taxes for such qualified real property by

(ii) the average annual effective interest rate for all new Federal Land Bank loans.

For purposes of the preceeding sentence, each average annual computation shall be made on the basis of the 5 most recent calendar years ending before the date of the decedent's death.

(B) *Application.*—The formula provided by subparagraph (A) shall be applicable regardless of whether the qualified real property or any portion thereof has in fact been rented or whether such qualified real property has been rented on a cash, crop shares, or other basis."

NATIONAL LEAGUE OF CITIES,
Washington, D.C., November 7, 1979.

Hon. HARRY F. BYRD, Jr.,
Russell Senate Office Building,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: The National League of Cities urges you to support a technical correction to the Revenue Act of 1978 dealing with the use of the investment tax credit for rehabilitation expenditures.

As you know, that Act extended the investment tax credit to qualifying rehabilitation expenditures made for commercial buildings over 20 years old. The purpose of this provision was to promote the renovation and modernization of older buildings, particularly in the Nation's central cities.

As a result of a technical oversight, however, the credit was not made available for qualifying rehabilitation expenditures made with respect to commercial buildings leased to noncorporate tenants, Federal, State, or local government agencies, or tax exempt organizations. S. 614, the Technical Corrections Tax of 1979, corrects the situation only with respect to non-corporate tenants, and not for governmental agencies and tax-exempt organizations. (The same is true of H.R. 2797, as approved by the House Ways and Means Committee.)

NLC urges you to amend S. 614 to make the investment credit available for the rehabilitation of buildings to be leased to governmental agencies and tax-exempt organizations. Such agencies and organizations are principal users of the large stock of older buildings in urban areas. Failure to do so would work against the clear Congressional objective of attracting private investment to rebuild the physical stock of our central cities.

Sincerely,

ALAN BEALS,
Executive Director.

OFFICE OF THE MAYOR,
Flint, Mich., November 8, 1979.

Hon. RUSSELL LONG,
Senate Finance Committee, Russell Building,
Washington, D.C.

DEAR SENATOR LONG: The City of Flint would appreciate inclusion of the following comments in the record respecting the Technical Correction Act of 1979:

It has come to our attention that the U.S. Treasury Department is considering limiting in some manner the use of the $20 million industrial revenue bond exemption connected with the Urban Development Action Grant program.

It is our strong convinction that distressed cities such as Flint need the full scope of what is known as the Bayh amendment without hindrance or limitation. Any attempt to qualify or limit this valuable investment tool, which is targeted for distressed cities, should be resisted.

The City of Flint and other UDAG eligible, distressed cities have high unemployment rates and excess capacity, which means that development directerd to such localities does not have the inflationary aspects of development likely to take place in more affluent areas.

By holding down the dollar amounts of the Urban Development Action Grants through increased use of industrial revenue bonds, we are actually saving Federal dollars.

Thank you for your consideration and concern regarding the multitude of problems facing distressed American cities.

Sincerely,

JAMES W. RUTHERFORD.

TRW, INC.,
Washington, D.C., November 13, 1979.

Hon. HARRY F. BYRD,
Russell Senate Office Building,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN. I understand that the Senate Finance Subcommittee on Taxation and Debt Management generally held hearings on November 7, 1979 on S. 873, a bill introduced by Senator Ribicoff. This bill would permit the Secretary of the Treasury to waive the foreign residency requirements of Sections 911 and 913 of the Internal Revenue Code for U.S. citizens who left jobs in Iran in late 1978 or in 1979 because of the revolution before fulfilling these residency requirements. The U.S. State Department advised Americans to depart at that time.

To induce U.S. employees to accept employment in Iran, many U.S. companies operating there, including TRW, guaranteed their employees that the additional living allowances they would receive while working in Iran would not result in additional U.S. income taxes. (Sections 911 and 913 of the tax code provide for this type of tax relief.) If S. 873 is not passed, these companies will be obliged to assume the additional tax obligations of those employees. It is noteworthy that our foreign competitors will not sustain these additional expenses—since the governments of other major industralized countries do not tax the income earned by their citizens from employment abroad.

Earlier this year, the Treasury Department, commenting on an identical bill (H.R. 3561) introduced in the House, informed Congressman Norman Dicks that it would not oppose such legislation. As a result, the President would presumably approve S. 873.

We hope that you will support favorable action in the subcommittee and the full committee on this bill.

Sincerely

MICHAEL MONRONEY,
Vice President,
Government Relations.

STATEMENT ON BEHALF OF TRW, INC.

This statement is submitted on behalf of TRW Inc. in connection with the Committee's consideration of § 103(a)(10) of the Technical Corrections Act, dealing with self-insured medical expense reimbursement plans.

TRW Inc. generally supports § 103(a)(10) (B), (C), and (D) of the H.R. 2797, but believes that there are numerous other technical defects in Code § 105(h) which should be considered by the Subcommittee, including an apparent serious need for postponement of the date on which this provision will take effect. As a result of the changes to § 103(a)(10) which were proposed by the Treasury Department late last week, however, additional study of these issues will be required. TRW Inc. will file a supplemental statement within the next few days incorporating a full discussion of the medical expense reimbursement issues, including the Treasury proposals.

Respectfully submitted,

CARROLL J. SAVAGE,
Tax Counsel.

SUPPLEMENTAL STATEMENT SUBMITTED ON BEHALF OF TRW, INC.

This statement is submitted on behalf of TRW Inc. in connection with the Committee's consideration of the parts of H.R. 2797 having to do with self-insured medical expense reimbursement plans.

Our firm is Washington Tax Counsel for TRW, which is a diversified manufacturer specializing in products, systems and services for electronic, space, aircraft, defense, automotive and other industrial and commercial markets. TRW and its subsidiaries and affiliates employ approximately 90,000 employees.

H.R. 2797 would amend various provisions of the Internal Revenue Code affected by the enactment of § 366 of the Revenue Act of 1978. The pertinent parts of the bill are § 103(a)(10) (A), (B), (C) and (D). These amendments are described at paragraphs 41 to 44 of the Joint Committee Staff description of H.R. 2797, dated March 14, 1979. In addition, the Treasury has proposed two additional amendments to § 366. See statement by Bradford L. Ferguson, Treasury Associate Tax Legislative Counsel, November 7, 1979. This statement on behalf of TRW takes into account the impact of those proposals as well as the amendments already included in H.R. 2797.

TRW supports all amendments to § 366 included in H.R. 2797 as modified by those recommended by the Treasury. However, TRW strongly urges that § 366 be further amended to delay its effective date for at least one year. The effective date aspects of this section clearly fall into the category of technical changes. Furthermore, an extension of time before implementation of this section is justified because, in addition to the technical defects already addressed in proposed amendments, there are many other technical problems in § 366 which it will be possible to properly resolve only through more study. Attempts to implement § 366 in its present form, or as amended as proposed by H.R. 2797 and the Treasury, would inflict social and economic costs on employers and employees which cannot be justified.

I. BACKGROUND

Prior to the Revenue Act of 1978 it had become commonplace for most employers to maintain some sort of a program under which the employer paid all or part of the costs of the employees' medical care. The growth of these plans was encouraged by the provisions of the Internal Revenue Code from permitting exclusion of such employer-furnished benefits from the taxable incomes of the benefited employees. The principal requirement of the Internal Revenue Code prior to the Revenue Act of 1978 was that the plan be for the benefit of employees, rather than for the benefit of shareholders. Medical expense plans flourished in no small part due to the fact

that there was a minimum of regulatory administrative burden on the sponsoring employer.

While self-insured medical expense plans have been a part of the small business picture for years, the move by large companies to self-insured medical benefit plans is a more recent phenomenon. Self-insurance enables a company to custom-design a benefits program to the needs of its employees without the underwriting restrictions of insurance carriers. In addition to added flexibility, self-insuring benefits through unfunded arrangements or through funded programs utilizing a so-called § 501(c)(9) trust produces significant cost savings. One actuarial firm, for example, estimates that the average savings to a corporation of utilizing a section 501(c)(9) trust rather than an insurance contract ranges from 5 to 15 percent of the benefits funded through the trust.[1]

Early in 1978, the Administration, as part of its proposals to Congress, recommended that anti-discrimination rules be imposed on employer-sponsored health care and other welfare benefit programs. After hearings on this proposal, the Ways and means Committee of the House of Representatives rejected the Administration proposal. In the final hours of its consideration of the Revenue Act of 1978, however, the Senate Finance Committee, without the benefit of public hearings or prior discussions, adopted an entirely new proposal which resulted in the additional of § 366 to the Revenue Act of 1978.

Section 366, adding a new subsection (h) to § 105 of the Internal Revenue Code, completely changed the tax rules with respect to self-insured medical expense reimbursement plans. New Code § 105(h), which is scheduled to become effective in 1980, taxes payments made on behalf of large segments of the employee population covered by employer-sponsored medical plans unless the plans are insured or satisfy the complex participation and benefit requirements of section 105(h). The new rules are based on unsound policy, will require costly standardization of benefits, will burden employers with needless additional paperwork and administrative concerns, and suffer from serious technical defects. These rules will deter the installation of medical expense plans for small groups and will significantly hamper efforts of large employers to reduce health benefit costs and/or improve benefits through the use of uninsured arrangements.

II. POLICY CONSIDERATIONS

Policy considerations reinforce the need for technical changes in Code § 105(h).

A. Section 366 is misdirected as an incentive for expended health care coverage

Because negligible revenue is expected from the new rules,[2] the only apparent policy objective of § 366 seems to be an attempt to encourage broader health plan coverage among the employed population by requiring nondiscriminatory plans or insured plans as a condition for favorable tax treatment for the more highly compensated employees, including management. While expansion of medical coverage is an indisputably worthy goal which TRW fully supports, the rules of § 366 as enacted will not operate to further that objective, and in fact will be counter productive.

Recent studies indicate that while only 76.8 percent of the U.S. civilian population is covered by private insurance for hospital care and 75.8 percent for surgical services,[3] the non-covered population is not the employed population. The most recent statistics available from the Bureau of Labor Statistics, for example, indicate that, during 1974-1976, 95 percent of the plant workers in the United States were covered by hospitalization benefits, 95 percent were covered for surgical benefits, and 92 percent for medical benefits. While only 40 percent of plant workers had catastrophic coverage in 1965-1966, by 1974-1976, 79 percent were covered by catastrophic benefits.[4] For office workers, during 1974-1976, 98 percent were covered for hospitalization, 98 percent were covered for surgical costs, 96 percent were covered for medical benefits, and 95 percent were covered for catastrophic benefits.[5] Two conclusions are apparent from these figures. First, basic medical protection is virtually universal among the employed population. Second, although these figures show some difference between plant and office workers when it comes to catastrophic

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[1] Cirino, "Benefits: The Quiet Debut of 501(c)(a) Trusts," *Institutional Investor*, May 1977, p. 58.

[2] The Joint Committee on Taxation estimates that § 105(h) will increase budget receipts by less than $5 billion per year.

[3] Marjorie Smith Carroll, "Private Health Insurance Plans for 1976: An Evaluation," *Social Security Bulletin*, September 1978, pp. 3-16.

[4] *1978 Handbook of Labor Statistics*, Bureau of Labor Statistics, Table 109, p. 372.

[5] *Ibid.*

health benefits, the percentage of plant workers with catastrophic coverage has been growing rapidly, having nearly doubled in the last fifteen years.

A recent study by the Congressional Budget Office provides an even more detailed analysis of the health-care coverage issue. According to this study, only 6.5 percent of all full-time wage earners are without health plan coverage, and over 80 percent of the uncovered population consists of part-time wage earners, self-employed individuals, unemployed individuals, and others not in the labor force.[6] Furthermore, since over one-fourth of the workers with health care benefits were in plans with waiting periods of three months or longer, a good portion of 6.5 percent of the full-time wage earners who are uncovered would probably be covered by a health care plan within a short period of time.[7]

There is no evidence to suggest that these facts were considered at all by Congress when § 366 was passed. TRW believes that § 366 is based on invalid assumptions and that there has been insufficient economic and sociological analysis of its ramifications Taxation of health care benefits should not be considered separately from the larger study of delivery of health care services presently underway in Congress. Delay in the effective date of § 366 will help remedy these policy objections by permitting time for public comment and staff consideration.

B. The new rules will require costly standardization of benefits

At the present time, the varieties of employer-sponsored health care programs and benefits provided are virtually limitless. TRW, a large employer which is widely diversified both functionally and geographically, maintains approximately 400 different medical benefit programs for its employees nationwide. The health care needs of employees in different areas and industries are so varied as to make it impossible to devise any one standard plan for all TRW employees. An electronics engineer, for example, has different health concerns and requirements than a machinist, and both have different needs than office workers.

Although § 105(h) as added to the Code by § 366 of the Act does not technically require standardization of benefits, because of the virtual impossibility of comparing benefits in different programs, self-insuring employers desiring to assure nontaxable benefits for employees will be required to offer precisely the same benefits to each and every participant. The rules leave no room to take into account the varying needs of the employees. Since similar benefits cost different amounts in different localities, true equality must be based on a comparison of benefits rather than costs. Even if costs were the same nationwide, however, § 105(h) would discourage the use of equally costly, yet different, benefits for different groups.[8] A plan today might, for example, cover a group of older, highly compensated management employees and a separate group of younger engineers. Since the needs of the older workers are different than those of the younger engineers, the plan might offer greater dental benefits to an office or management group. Better maternity benefits, however, may be provided to the engineers. An employer should not be required to extend dental benefits to younger groups instead of improved maternity coverage merely because the older employees are more highly compensated, but uncertainties concerning discrimination will produce such results.

In addition to undermining the employer's efforts to best fulfill employee needs, Code § 105(h) will often prevent an employer from taking into account the employer's own needs. An employer may provide different benefits to employees within certain job classifications for perfectly valid business reasons. An obvious example of such a distinction is the case of highly-compensated airline pilots or other employees in high risk jobs where physical fitness is of paramount importance. An employer may well want to provide superior preventative care to these employees because of the nature of their jobs, a valid policy which under § 105(h) will be possible to implement only by assumption of the cost of insuring benefits through a licensed insurance company.

In summary, the size of the employee group, the age and sex makeup of the group, the geographical location of the group and numerous other factors influence the design of employer-sponsored health care plans. The factors which must be taken into account in determining the health care needs of a diverse population of employees cannot be reduced to a common denominator without adding needless expense to a health care system already in desperate need of cost containment.

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[6] U.S. Congressional Budget Office, Profile of Health Care Coverage: The Haves and the Have-Nots, 1979, pp. 19-21.

[7] *Ibid.*

[8] Colvin, "Coping with the New Anti-Discrimination Requirement of Medical Reimbursement Plans," 50 *Journal of Taxation* 104, February 1979.

C. The new rules will significantly increase the paperwork and administrative burden

One of the most desirable features of pre-§ 105(h) medical expense plans is that employers are not encumbered with substantial and burdensome restrictions on the operation of these plans. The new rules under § 105(h) will create substantial complexity in the administration of a self-insured plan.

As noted above, TRW maintains over 400 different health benefit programs for employees throughout the United States. Certainly TRW, together with most other employers, will want to assure employees that the health benefits continue to be nontaxable. Although no advance rulings from the Service are required under § 105(h), the potential tax impact on employers will require that it become standard operating procedure for companies like TRW, who increasingly will wish to self-insure these benefits, to apply to the Internal Revenue Service for advance rulings. If the determination letter process for pension plans is any measure, the costs and time involved in applying for such an advance determination will be enormous. Unlike pension and profit sharing plans, furthermore, medical plans are in a constant state of flux. At TRW, for example, an average of 100 changes, generally in the nature of benefit improvements, are made to the medical programs in any given year. If, as we expect, TRW would be constrained to apply for an advance ruling each time that benefits for highly-compensated employees are changed, TRW will be filing scores of ruling requests each year. Since most plan changes are benefit improvements based on current perceptions of shifting employee needs, the ruling process will merely impede the implementation of improvements in an area where timing and flexibility are of utmost concern to the covered group.

The complexity involved in administering the statute can be seen by examining the benefit schedule of a typical, albeit fairly simple, self-insured plan set forth in Exhibit 1. This employer maintains three separate benefit schedules within its self-insured plan. As can be seen by this exhibit, each benefit schedule has certain advantages over each of the other alternative schedules. Alternate I, for example, only has a $50 deductible, whereas the main plan has a $75 dedductible. The main plan, however, has a $250,000 lifetime maximum, whereas the alternate plan has a $100,000 lifetime maximum. Imagine this chart with 400 different programs and it becomes apparent that the permutations between the various schedules are endless. Short of obtaining a ruling every time a benefit is changed, there is simply no way for a plan administrator to know whether these variations will be deemed discriminatory.

TRW pioneered the development of nondiscriminatory elective flexible benefit ("cafeteria plan") programs, the tax treatment of which is now formalized in Internal Revenue Code § 125. Widespread development of cafeteria plans could help to mitigate some of the problems discussed above. However, the "cafeteria plan" concept necessarily involves complexities which make it unsuitable for smaller companies and difficult to extend to geographically diverse groups. Many years will be required before the concept is sufficiently developed to avoid the need for postponement of the impact of Code § 105(h).

III. MISCELLANEOUS TECHNICAL DEFECTS

The rules of Code § 105(h) as they presently stand suffer from a variety of defects and ambiguities. No one is even certain of the types of arrangements covered by the rules. For example, it appears that Blue Cross-Blue Shield plans and Health Maintenance Organizations (HMO's) may be subject to the new rules because these organizations may not be "licensed insurance companies" within the meaning of the Senate Finance Committee Report.

While there are undoubtedly numerous other problems which have not yet surfaced, the following is a brief list of some of the technical problems that must be resolved before Code § 105(h) can be applied:

1. What is a "benefit" under these rules? If, as in Exhibit 1, a plan provides different lifetime maximums for different employees, are different "benefits" involved? What if there are different deductibles? What if one benefit is provided for a fixed number of days and another benefit is not? What if one schedule of benefits has no limitations on reimbursements for services performed outside a certain geographic area and another limits such coverage to 100 percent of the first $3,000 of expenses and 80 percent of expenses between $3,000 and $50,000?

2. What is a policy of accident or health insurance? Is risk shifting required? Is pooling of risk enough? Are benefits provided by a Health Maintenance Organization (HMO) provided under "insurance"? Is Blue Cross-Blue Shield a "licensed insurance company" within the meaning of the Senate Finance Committee Report? What if a captive insurance company is involved? What of an experience-rated

insurance contract under which premiums are closely geared to claims? Does a § 501(c)(9) trust or a multiple employer trust qualify as "insurance"?

3. If an employer has more than one "plan" and each "plan" covers a nondiscriminatory group, do benefits under the one plan have to be compared with benefits under the other?

4. If a plan covers certain highly compensated collectively bargained employees (e.g. airline pilots) as well as non-collectively bargained employees, do the benefits provided to the collectively bargained employees have to be included in the excess reimbursement calculations if the plan fails to meet the coverage tests?

5. How does one test discrimination in favor of the highest paid 25 percent of employees when there are less than four employees?

6. What is the effective date of § 105(h)? If a plan is on a calendar year and reimbursement for the 1979 plan year is made after December 31, 1979, does § 105(h)(10) require these reimbursements to be included in a participant's 1979 tax return?

The amendment included in H.R. 2797 and the additional amendments proposed by the Treasury do not address any of these serious problems. Unless the effective date of § 366 of the Revenue Act of 1978 is extended, numerous employees throughout the country will find themselves taxable on medical benefits. Since it is expectable that the top 25 percent of employees in terms of compensation will include large numbers of employees earning between $10,000 and $15,000 [*], where high levels of coverage are provided it is not inconceivable that the amounts so taxable in cases of serious family illness could be in excess of an employee's total compensation.

It is not feasible in the time remaining before January 1, 1980 to resolve all of the defects in Code § 105(h). TRW therefore strongly urges that the effective date be postponed.

[*] According to figures available from the Census Bureau, an individual with salary or wage income of just over $14,000 would rank in the top 25% of U.S. wage earners. U.S. Census Bureau, Money Income in 1977 of Families and Persons in the U.S. (P-60 —118), Table 49, pp. 204-209.

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______ CORPORATION

COMPARISON OF "MAIN PLAN" BENEFIT STRUCTURE

WITH TWO ALTERNATES

Description of Benefits	"Main Plan"	Alternate I	Alternate II
	Comprehensive Major Medical 100% of R&C for: - Hospital - Surgical - Doctor Calls in Hospital - X-Ray and Lab - Radiotherapy $100 Supplemental Accident $250,000 Lifetime Maximum $75 Deductible ($150 per family) Coinsurance - 80% with 100% after $2,500	**Major Medical** $100 Supplemental Accident $100,000 Lifetime Maximum $50 Deductible ($100 per Family) 80% Coinsurance	**Basic Medical** Hospital 100% - 365 Days Surgical 100% - R&C Doctor Calls: - Home/Hospital $5 - Office $4 $200 X-Ray and Lab $300 Supplemental Accident **Major Medical** $150,000 Lifetime Maximum $50 Deductible ($100 per family) 80% Coinsurance
Advantages Within - "Main Plan"	N/A	- First dollar (100%) Hospital, Surgical, etc. - $250,000 Lifetime Maximum - 100% after $2,500	- 100% Hospital not limited to 365 days - Doctor Calls in-hospital at R&C - 100% X-Ray and Lab not limited to $200 - $250,000 Lifetime Maximum - 100% after $2,500
- Alternate	N/A	- $50 deductible ($100 per family)	- $300 Supplemental Accident - Home and office doctor calls at 100% - $50 deductible ($100 per family)
Employees Covered	Covers seven divisions (each division having both hourly and salaried employees). Total number of employees - 12,900.	Covers one division (with both salaried and hourly employees) Total - 69 employees.	Covers one division (with both salaried and hourly employees). Total - 850 employees.

SUTHERLAND, ASBILL & BRENNAN,
Atlanta, Ga., November 14, 1979.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: This statement, which proposes an amendment to the Technical Corrections Act of 1979, is submitted to the Subcommittee on Taxation and Debt Management of the United States Senate Committee on Finance, on behalf of Lawyers' Title Guaranty Fund. It seeks a postponement of the effective date of the amendments made by the Revenue Act of 1978 to section 404 of the Internal Revenue Code of 1954. The proposal is narrowly drawn, and, as described more fully below, is clearly technical in nature.

The Revenue Act of 1978 amended section 404 of the Internal Revenue Code to extend to independent contractors existing provisions of the Code denying the deduction of compensation accrued but unpaid under a deferred payment plan. These provisions had previously been applicable only with respect to payments to employees. The Act also amended section 404 to include *any* plan deferring the receipt of compensation rather than only stock bonus, pension, profit sharing, annuity plans or similar plans, as previously provided. There was no effective notice to taxpayers or the public of the nature or significance of these changes before they were enacted. They were made effective for taxable years beginning after December 31, 1978, only a few weeks after the Act became law.

The new law drastically affects Lawyers' Title Guaranty Fund of Florida, an unincorporated business trust title insurer having as members approximately 6,000 Florida lawyers, and its basic agreement for compensation to these members for their issuance of title insurance policies. Under court decision (*Lawyers' Title Guaranty Fund* v. *United States*, 508 F.2d 1 (5th Cir. 1975)) and IRS ruling expressly accepting that decision (Rev. Rul. 77-266, 1977-2 C.B. 236), the compensation has been deductible when accrued and credited to "current allowance accounts" maintained for members, even though, to protect the financial integrity of the Fund, the amount is not payable for seven years, the statutory period in Florida for adverse possession of real property.

The 1978 amendments to section 404(b) and section 404(d) of the Internal Revenue Code have the effect of denying to the Fund, effective January 1, 1979, any deduction for obligations credited to members' current allowance accounts until they are actually paid out to members. In past years, after taking into account deductions of accrued obligations credited to the "current allowance accounts," the Fund's taxable income was attributable largely to return on investments. Without the deduction, the current tax burden of the Fund for 1979 will be many times larger than normal even though the current obligations to members will be undiminished. The Fund is not heavily capitalized and this will seriously affect its present financial position and ability to compete with other title insurance companies.

The Fund seeks a transition period of one year during which the application of the Act would be postponed. Plans are being made to amend the Fund's Declaration of Trust with respect to obligations to members created after January 1, 1980, and, in effect, to reduce any newly created obligations to members by the amount of tax applicable thereto, but this cannot be done for the year 1979. The full year is needed by the Fund to adapt its operations and agreements with members to a new plan of operations which takes into account the provisions of the 1978 Act.

Representatives of the Fund are not aware of any other type of business upon which these provisions of the new Act would have such a drastic impact. The particularly distinctive features of the Fund are that it is a membership type insurance fund in which most of its operating income, after excluding investment income and other expenses, is offset by deferred obligations to members in consideration for their issuance of title insurance policies. Thus, the accrual of the deferred compensation has been a central and dominant feature in the Fund's accounting for tax, regulatory and financial purposes. Extensive planning during the year 1979 has been required by the Fund to adjust to the new circumstances created by the Act. This is not a common problem of taxpayers affected by the Act and, therefore, the proposed amendment is narrowly drawn.

The Fund had no reasonable opportunity to call to the attention of Congress the impact of the Act on the Fund and its inability to adapt to the new provisions within the limited time allowed. Thus, the special considerations applicable to the Fund apparently were not taken into account in enacting this legislation. Even though the amendments made a significant change to existing law, the amending section was termed a "clarification." This may well indicate that even the drafters

of the legislation did not then have in mind the extremely broad scope of the provision as it applies to the Fund.

It is clear that the proposed amendment is technical in nature and would not represent a policy change. Although it is adversely affected by the changes in section 404 made by the 1978 Act, the Fund does not seek to reverse these policy decisions or to modify the new language of section 404 in any way whatever. Instead, the Fund merely seeks a narrowly-drawn one-year postponement of the effective date of the changes so that it may adapt its operations to them. Congress undoubtedly would have provided for such a transition period in the 1978 Act had it been aware of the unique and extremely disruptive effects of the changes on the Fund's operations. A one-year change in the effective date of a provision is inherently technical, and does not represent a policy change.

The proposed amendment is attached.

Respectfully submitted,

RANDOLPH W. THROWER.

ACT SEC.—. EFFECTIVE DATE OF CLARIFICATION OF DEDUCTIBILITY OF PAYMENTS OF DEFERRED COMPENSATION, ETC., TO INDEPENDENT CONTRACTORS

Act Sec.—. Section 133 of the Revenue Act of 1978 (relating to clarification of deductibility of payments of deferred compensation, etc., to independent contractors) is amended by striking out subsection (c) thereof and substituting therefor a new subsection (c):

(c) Effective date—The amendments made by this section shall apply to deductions for taxable years beginning after December 31, 1978, except that subsection (a) shall not be effective for taxable years beginning before January 1, 1980, with respect to a plan which defers the payment of amounts credited by an unincorporated title insurance company organized as a business trust—

(1) which is engaged in the business of providing title insurance coverage on interests in and liens upon real property obtained by clients of members, and

(2) which is subject to tax under section 831 of the Internal Revenue Code of 1954,

to separate accounts for such members in consideration of their issuance of policies of title insurance, where no part of such amounts is payable to or withdrawable by the members until after the period of adverse possession of real property under applicable state law.

PREPARED STATEMENT OF ROBERT HALLIDAY, PRESIDENT, STAMFORD HISTORICAL SOCIETY, STAMFORD, CONN.

EXTENSION OF IRC SECTION 2055(E)(3) THROUGH DECEMBER 31, 1979

§ 2055(e)(2) was adopted in 1969 and provided that thereafter only certain types of charitable remainders would continue to qualify for a deduction for Federal Estate Tax purposes. However, because of the harshness of its application, transitional provisions were made from time to time through 1978 to permit non-qualifying wills to be conformed to meet the requirements of the section (§ 2055(e)(3)).

The most recent extension, made by Public Law 95-600, was for one year until December 31, 1978 and came in on the Senate side.

Previously, Public Law 94-455 had continued the extension until December 31, 1977. This also came in from the Senate Finance Committee.

There are still old wills in existence which need the help of § 2055(e)(3) to conform to the requirements of § 2055(3)(2).

A one year extension is needed for the benefit of those cases where decedents died in 1979.

A particularly hard case indicating the need for extension is a recent legacy to a Connecticut charity from a long time supporter who died on October 8, 1979 at age 81. The lawyer who drew the will died some 5 years ago and his legal firm was discontinued.

The decedent had no real chance to change her will because she was bed-ridden in the hospital for over 6 years, had suffered the amputation of a leg, and was under sedation until she died on October 8, 1979.

Fairness and equity strongly favor a further extension through December, 1979 of the provisions previously adopted to enable the conformation of old wills to the new requirement.

NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION,
Washington, D.C., November 7, 1979.

Hon. HARRY BYRD,
Chairman, Senate Finance Subcommittee on Taxation and Debt Management,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: I am writing on behalf of the employees of the rural electric cooperatives and their associations in support of HR 2797, the Technical Corrections Act of 1979, as passed by the House of Representatives July 16, 1979. The National Rural Electric Cooperative Association (NRECA) is the national service organization for almost 1,000 rural electric systems which serve in 46 states throughout the United States.

This letter wishes to express general support for HR 2797 and specifically, Section 101(a)(4) "Amendment related to Section 131 of the Act" which we feel more correctly fulfills the intent of Congress when it passed the Revenue Act of 1978 (Public Law 95-600).

In the Revenue Act of 1978, Congress preserved the availability of deferred compensation for the employees of rural electric cooperatives and their national organizations. The language of Section 457 of the Internal Revenue Code (deferred compensation) in defining rural electric cooperatives and the membership characteristics of their associations, unintentionally omitted employees of a few rural electric cooperatives and one of their national service organizations.

As passed in the 95th Congress, deferred compensation programs of rural electric cooperatives and certain of their affiliates were included in the provisions applying to State and Local government deferred compensation plans. Section 457(d)(9)(B)(i) of the Code defines a rural electric cooperative as "(i) any organization described in section 501(c)(12) which is exempt from tax under section 501(a) and which is engaged primarily in providing electric service, . . ."

Most rural electric cooperatives are indeed exempt from tax under section 501(c)(12) except for some in the Tennessee Valley Authority area. in *U.S.* v *Pickwick Electric Membership Corporation*, 158F2d 272 (CCA 6, 1946), the cooperatives in the 6th Circuit were given the right to obtain tax exemption as a nonprofit organization operated for the promotion of social welfare under section 501(c)(4). To briefly explain, to maintain tax exemption under section 501(c)(12) no more than 15 percent of income received may be derived from nonmembers. In the TVA area, some cooperatives were required to service electric customers who were not members, and, therefore, tax exemption was being revoked due to noncompliance with the 15 percent income limitation. Accordingly, the 6th Circuit permits exemption under a different portion of the Code.

The language of the Revenue Act of 1978 would then prohibit these rural electric cooperatives from offering their employees the opportunity to participate in a deferred compensation program. Also, as will be further explained, NRECA would be prohibited from administering the deferred compensation program because these 501(c)(4) cooperatives are members of our organization. We believe this was not the intent of the legislation.

There is another discrepancy in the legislative language in the accompanying paragraph (ii) relating to the affiliated organizations. This section permits the employees of the State and national affiliated service organizations to participate in the program. The definition of these organizations states "any organization described in section 501(c)(6) which is exempt from tax under 501(a) and *all* the members of which are organizations in clause (i)" (my emphasis). This causes NRECA a compliance problem.

NRECA, as the title connotes, is the NATIONAL service organization of not only the individual local rural electric cooperatives described in (i), but our membership also includes other rural electric-related nonprofit organizations, for example statewide service associations of the rural electric systems.

To further give an outline of our membership, let me digress briefly. NRECA's membership totals 1,029. The breakdown of membership follows:

953 (93 percent) rural electric cooperatives providing electric distribution, generation, and transmission services on a mutual or cooperative, nonprofit basis. These would be 501(c)(12) and 501(c)(4) electric cooperatives; rural public power districts in the State of Nebraska that function akin to a rural electric cooperative, however, they are an instrumentality of the State and exempt from tax under 501(c)(1) (employees would be covered as local government employees for the purposes of deferred compensation), and public utility districts in the State of Washington (again the same type of rural electric service).

39 (3 percent) the Statewide service/membership organization exempt from tax under 501(c)(6) and whose employees may participate under clause (ii).

28 (3 percent) cooperative or nonprofit groups meeting the criteria of NRECA membership which is to closely relate to the furnishing of electric service in predominantly rural areas. These members, for example, are computer service centers owned by electric cooperatives, credit unions of rural electric cooperative employees, a municipally-owned electric wholesaler, regional associations of rural electric cooperatives, etc.

9 (less than 1 percent) foreign electric cooperative affiliates that have received technical assistance from NRECA in conjunction with the Agency for International Development programs. The employees of these cooperatives, of course, could not participate in any deferred compensation program; the cooperative is merely a member of NRECA.

Please note, employees of these groups may participate in a deferred compensation program only if the employer is described in clause (i) or (ii). We are supplying this information only to illustrate that NRECA's membership is not solely composed of rural electric cooperatives exempt from tax under 501(c) (12) and (4). An appropriate language change as contained in the House-passed bill is necessary to accurately describe our membership.

One other national cooperative organization which shares the rural electric cooperative membership of NRECA should be included in the definition in clause (ii). This is the National Rural Utilities Cooperative Finance Corporation (CFC) which is a cooperative of cooperatives and exempt from tax under section 501(c)(4). It is also a member of NRECA. This organization was founded to provide financial assistance to the rural electric cooperatives supplemental to that provided by the Rural Electrification Administration. So, like NRECA, CFC is also a rural electric cooperative organization whose employees should have the opportunity to participate in a deferred compensation plan administered for the cooperatives by NRECA.

The changes outlined herein are not intended in any way to change the intent of Congress. We feel the exclusion of the 501(c)(4) cooperatives and service organization was an oversight and the change in definition in (ii) will only serve to more correctly describe the complexion of the membership of the rural electric cooperative service organizations.

I appreciate the Subcommittee's time, consideration, and continued support of these changes to the Revenue Act of 1978 as passed the House of Representatives. I ask that this letter be included in the hearing's record.

Sincerely,

CAROLYN HERR WATTS,
Legislative Representative.

PREPARED STATEMENT OF RAYMOND B. ONDOV, THE HORMEL FOUNDATION

The Hormel Foundation respectively urges the Committee's approval of an amendment to H.R. 2797, the Technical Corrections Act, which would add S. 1190 to the bill. This measure would permit The Hormel Foundation, as a private foundation, under expressly limited circumstances, to serve as a trustee of a trust in which it possesses a beneficial interest, even though such trust is a "disqualified person" for purposes of section 4941. This bill establishes a limited exception to relieve a hardship created for The Hormel Foundation in a recent interpretation by the Internal Revenue Service of section 4941.

BACKGROUND

The Hormel Foundation was incorporated under the laws of the State of Minnesota in 1941 as a charitable foundation. The assets are derived from gifts and bequests to the Foundation and from certain purchases. The Foundation may only make grants to charitable organizations qualifying for exemption under section 501(c) of the Code.

The Foundation presently owns outright 91,537 shares or 1.91 percent of the outstanding common stock of Geo. A. Hormel & Company.

In addition to its other charitable and educational purposes, The Hormel Foundation acts as the duly court appointed and qualified trustee of twenty-one irrevocable trusts created by George A. Hormel, Lillian B. Hormel, his wife, and Jay C. Hormel, his son. All such court appointments were confirmed prior to 1961 and some as early as 1954, and the trusts have been continuously under court supervision since those dates.

All of these trusts were irrevocable by August 30, 1954 and some of them prior to that time.

The Hormel Foundation has a beneficial interest in each of the trusts of which it serves as trustee. Indeed, under the laws of Minnesota, the Foundation may act as Trustee for only those trusts in which it has such a beneficial interest. *Minnesota Statutes 317 et seq.* In addition to the shares which are owned outright by The Hormel Foundation, the trusts of which it is trustee contain 2,066,019 shares of common stock of Hormel Company which represents an additional 43.01 percent of the total outstanding common stock of Hormel Company.[1] The Foundation, as Trustee, votes these shares at Hormel Company stockholders' meetings. The life beneficiaries of these various trusts are family members of Jay C. Hormel.[2] The life income paid these beneficiaries is fully taxable as in any private trust and no income tax avoidance occurs. Upon the death of the family members, the Foundation will own 1,919,029 shares or 39.95 percent of the outstanding common stock of Hormel Company.[3]

The Foundation has never charged a trustee's fee against the trusts, but has always been reimbursed by the trust for any expenses incurred in their administration. The books and records of the Foundation have been and are audited by independent certified public accountants, and separate and complete accounts are maintained for the funds administered by the Foundation as trustee for the trusts. *No charitable funds are expended or used for the benefit of the trust.*

During the period in which the Foundation has acted as Trustee of these trusts, the Foundation has been audited by the Internal Revenue Service at various times and its exempt status has never been challenged. The Internal Revenue Service consistently rules that the Foundation was not engaging in prohibited transactions under the provision of prior law.[4] In 1971, the Service ruled that the Foundation qualified for exemption from the provisions of section 4941 until 1979 under section 101(1)(2)(D) of the Tax Reform Act of 1969, if the provision of services to the trusts was prohibited by section 4941 of the Code.[5]

In response to a request for a letter ruling by the Foundation, on July 29, 1977, the Service ruled that services rendered by the Foundation to the trusts was an act of self dealing under section 4941 of the Code, which would prohibit the continued provision of those services for taxable years beginning after December 31, 1979. The Foundation disagrees with the Service. While the ruling literally applies the requirements of section 4941, the Hormel Foundation believes the result was unintended by Congress and would create a hardship which justifies this requested legislation.

Immediately following receipt of the IRS ruling, the Foundation actively sought relief from the substantial adverse effects of the ruling. H.R. 12592 (which is identical with S. 1190 introduced in this Congress) was passed unanimously by the House of Representatives on October 10, 1978, but it was not acted upon by the Senate Finance Committee or considered by the Senate because by then the Congress was about to adjourn.

On February 15, 1979, H.R. 2173, which is identical with H.R. 12592, was introduced in the House of Representatives where it is presently pending.

The adverse IRS ruling requires passage of this remedial legislation as soon as possible in order to avoid the risk of harsh penalties being imposed upon the Foundation.

During consideration of H.R. 2173 before the House of Representatives the Treasury Department, on June 27, 1979, suggested that the Foundation should seek judicial relief. Subsequently, the Joint Committee on Taxation requested the Minnesota Attorney General to furnish the Committee with information concerning Minnesota trust law which bears upon the proposed legislation. By letter dated July 26, 1979, the Minnesota Attorney General responded to the Committee's request. A copy of the Attorney General's letter is attached as Appendix D. The Attorney General's letter refutes the Treasury Department's position concerning the pathway of judicial relief to the Foundation.

Under Minnesota law, the Attorney General is charged with the responsibility of enforcing laws relative to charitable entities. The Attorney General's letter dated July 26, 1979, states:

"Although a clear violation of the self-dealing provisions of 26 U.S.C. Sec. 4941, or the parallel provisions of Minnesota Statutes Section 317.165(2) and 501.115(b) (1978) would be a potential basis for removal, it is doubtful whether a letter ruling of the I.R.S. would be sufficiently final or conclusive to establish a violation. Under these

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[1] Details relative to these trust holdings are found in Appendix A attached.

[2] See Appendix A.

[3] See Appendix A.

[4] Section 503(b) contained penalties for prohibited transactions, including a foundation making ". . . any part of its services available on a preferential basis to . . . a member of the family."

[5] A copy of the letter ruling is attached as Appendix B.

circumstances, it appears unlikely that the Foundation would be removed involuntarily."

The Foundation is faced with the following dilemma. It cannot obtain a court determination as to whether or not it is violating 4941 until after the IRS has charged a violation of 4941. The charge will not be made by the IRS until some indefinite time in the future which will be long after any claimed act of violation occurs and has continued to occur. Until the Foundation is charged with a claimed violation, it is forced to expose itself to the harsh penalties of 4941.

It is neither wise judgement nor prudent administration to expose the Foundation to the risks involved. In order to avoid subjecting the Foundation to these risks and to resolve the dilemma it seeks legislative relief.

THE HORMEL FOUNDATION

The Hormel Foundation (the "Foundation"), is a philanthropic organization incorporated under the laws of the State of Minnesota in December, 1941, for religious, charitable, scientific, literary or educational purposes, with power to "establish, promote, aid, or engage in business for the purposes mentioned." The plan of the Hormels was that ultimately the Hormel Foundation would control Geo. A. Hormel & Co., through holdings of capital stock in the latter. The Foundation was granted perpetual existence, and issued no capital stock of its own.

Membership of the Hormel Foundation is limited, according to the Articles of Incorporation, to not less than five persons, nor more than fifteen. One-third of them must be competent businessmen, one an experienced attorney-at-law. All must be persons whose chief financial interests shall be within the City of Austin and vicinity, or Mower County, Minnesota, and a majority must be residents and freeholders of the County.

A substantial step in the fulfillment of the purposes of the Foundation was taken within a year of its incorporation with the establishment of the Hormel Institute as a unit of the Graduate School of the University of Minnesota. The purpose of the Hormel Institute is to promote education and research, and has achieved such an outstanding reputation that today federal and state agencies contribute substantial sums to its programs. The Institute is the recipient of the most substantial sums from the Foundation, and its current budget approaches two million dollars annually.

Substantially all of the Hormel Foundation's assets were contributed to it from three sources: George A. Hormel, founder of the Hormel Company; Jay C. Hormel, his son; and Hormel Incorporated, which was a personal holding company of the Hormel family, terminated prior to the Tax Reform Act of 1969.

George A. Hormel and Jay C. Hormel were very remarkable men. Both were imbued with a spirit of loyalty and dedication to reinvest in the betterment and welfare of their employees, the community of Austin, Minnesota, and society in general. Because of the philosophies of these men, the Hormel Company has been a leader in establishing generous programs for the welfare of its employees, including the guaranteed annual wage, profit hearing, and the like.

The establishment of the Foundation and the Hormel Institute are additional evidence of the Hormel's generosity and desire to help and improve the less fortunate and our society generally.

In addition to other philanthropic purposes of the Foundation, an extremely important charitable purpose of the Foundation is to hold and retain the controlling interest in the Hormel Company, for the benefit of those communities in which the company has established plants or processing facilities, particularly Austin, Minnesota. Austin is a county seat community of approximately 25,000 people. The surrounding area is agricultural, and Austin is classified as a one-industry city because such a substantial portion of its income is dependent upon the Hormel Company. The general executive offices of the company and the company's oldest and largest plant are located in Austin, employing over 3,100 persons. The standard of living and home ownership is high due largely to the economic stability which has been provided by the company.

The Hormels felt a tremendous obligation to protect and preserve Austin, Minnesota, a community which they fostered and which was largely dependent for its continued existence upon the company which they had created. The Hormel Foundation was the entity they chose to accomplish the objective of protecting and preserving that community. The Hormels developed a plan whereby the Foundation would presently hold and ultimately own controlling interest in the Hormel Company. During the course of planning, Jay C. Hormel summarized this intent in a letter written in 1942:

With respect to control of Hormel, Inc. in case I should predecease my father, I don't see how inheritance tax liabilities possibly could be met in such way as to leave that control with him or with executors of my estate. However, if the Hormel Foundation stands up for the purpose of which it is intended, it will hold that part of my stock which cannot be left in the hands of my family or my executors, and will vote that stock in the same interests which Father or I would have in mind; namely, the protection of the integrity of this business in behalf of the community which is dependent on it. . . .

This dominant intent to place controlling interest of the Hormel Company in the Foundation in its own behalf and as Trustee is evidenced by the direct gifts of stock to the Foundation and the creation of numerous trusts into which substantial stock interests were deposited.[6] Twenty-one Hormel trusts were established over a period of years extending from October 20, 1934, when the first trusts were established, through August 30, 1954, when Jay C. Hormel died and the final trust created under his Last Will and Testament became irrevocable. Throughout this period, the plan to maintain control of the Hormel Company for its charitable purposes and the preservation of the community of Austin was undergoing scrutiny and development. These trusts are the result of the years of intense and detailed planning by George A. Hormel and Jay C. Hormel, whose honorable intention with respect to the trusts and the Foundation are well documented.

On at least two occasions, Jay C. Hormel publicly expressed and acknowledged that one of the primary intents and purposes for the establishment of the Foundation was the preservation of Austin, Minnesota, by preservation of the controlling interest in the Hormel Company within the Foundation. As Chairman of the Hormel Company, Jay C. Hormel expressed his plan to the annual stockholders' meeting in 1948:

It is for these practical reasons that this Company considers itself tremendously dependent upon the well-being of Austin and the livestock area we serve. For that reason in turn every possible precaution has been taken to see to it that whatever may happen to individual fortunes, the ownership and control of the Company will remain in Austin.

One of the agencies which will contribute to this purpose in the Hormel Foundation. The Hormel Foundation was established as a public corporation for scientific, educational, and public interest purposes within Minnesota, particularly in the vicinity of Austin and Mower County. The Hormel Foundation is a trusteeship which will eventually hold a large ownership in Geo. A. Hormel & Company and can be counted on to so vote its stock in the company as to make sure that control will never be exercised in a way which fails to keep the best interests of Austin and the surrounding community as its prime purpose.

Similarly, in 1949, Jay C. Hormel, as co-founder of the Hormel Foundation, stated at the dedication of the Hormel Institute:

The Hormel Foundation was established as a public corporation for scientific, education, and public interest purposes within Minnesota, particularly in the vicinity of Austin and Mower County. The Foundation is a trusteeship which will eventually hold a large ownership in Geo. A. Hormel & Co. and can be counted on to so vote its stock in the company as to make sure that control will never be exercised in a way which fails to keep the best interests of Austin and the surrounding community as its prime purpose.

The present beneficiaries of nineteen of the twenty-one trusts have previously acknowledged, supported and ratified the expressed purpose and intent of Jay C. Hormel, George A. Hormel and Lillian B. Hormel to place with and have retained in the Foundation and the trusts the controlling interest of Geo. A. Hormel & Company. The beneficiaries have stated in affadivits presented to a Minnesota Probate Court that it was the intention of the grantors to place a controlling interest of the Hormel Company in the trusts and the Foundation.

The retention of the Hormel Company stock and the trusteeship of the trusts by the Foundation has not only fulfilled the intention of the Hormels in their creation, but has served the charitable purposes intended by the Hormels for the benefit of Austin, Minnesota and society in general. The Foundation has never failed to distribute its income and consistently distributes the income on a current basis. The Foundation has never engaged in self-dealing. It has never made investments which would jeopardize its charitable purposes, nor has it engaged in any speculative trading activities. The Foundation does not borrow or lend money. It has no unproductive assets.

The Foundation has never expended any money for items classified as "taxable expenditures" under Section 4945 of the Code. It has never attempted to influence

[6] Details relative to the trust holdings are set forth in Appendix A.

legislation, or to influence the outcome of any election. It has never made a grant to an individual for any purpose. The Foundation has never engaged in any financial transactions unrelated to its charitable purposes, nor has it ever had any unrelated business income.

From the date of its incorporation until November 30, 1978, the total income of the Foundation equalled $9,050,382.00. For this same period, administration expenses totalled only $658,234.00, and the Foundation contributed a total of $8,801,198.00 to tax exempt, charitable, educational, religious, and scientific organizations. It is apparent that the Foundation's income has been very substantial, while the cost of administration has been minimal. Substantially all of the income of the Foundation has been derived from dividends on Hormel Company stock.

The total estimated tax benefits to the Hormels for contributions to the Foundation were $485,000.00. This tax saving is insubstantial when compared with the benefits received from the Foundation since its creation, and its record proves that it has truly fulfilled the role intended by Congress when exemption from taxation was granted.

The honorable intentions of the creators of the Foundation and its donors are well established and should be preserved. There was no evil, nor is there any evil, in using the Foundation as the means to fulfill the objectives for Austin and society which were sought by the Hormels. If the Hormels had any suspicion that the law would one day attempt to nullify and destroy this means, they would have prescribed another method. They were all deceased long before the enactment of the Tax Reform Act of 1969, and all of their trusts and plans were irrevocable at least fifteen years prior to enactment.

THE IRS RULING

On July 29, 1977, the Internal Revenue Service issued a ruling to the Hormel Foundation concluding that, where a trust is a "disqualified person" (i.e. where a "disqualified person" owns more than 35 percent of the beneficial interest in the trust), rendering services to the trust by the Foundation will constitute an act of self-dealing. The ruling is based upon a literal interpretation of Section 4941 of the Code, which reads in pertinent part:

(a) SELF-DEALING.—

(1) *In general.*—For purposes of this Section, the term "self-dealing" means any direct or indirect . . . (C) furnishing of goods, services, or facilities between a private foundation and a disqualified person . . .

(2) *Special rules.*—For purposes of Paragraph (1)— . . . (D) The furnishing of goods, services, or facilities by a private foundation to a disqualified person shall not be an act of self-dealing if such furnishing is made on the basis at least as favorable as that which such goods, services or facilities are made available to the general public.

The Service ruled that the Foundation was incapable of rendering services as trustee to the general public under Minnesota's law, and, even if it were rendering such services to the public, the services are not substantially related to the Foundation's charitable purposes pursuant to the requirements of Section 53.4941-(d)(3)(b)(1) of the Regulations. Therefore, upon expiration of the present exemption under § 101(10)(2)(D) of the Tax Reform Act of 1969 and the I.R.S. letter ruling issued on September 14, 1971, pursuant to that exemption, the Hormel Foundation will have to cease trusteeship of the trusts. This exemption terminates for taxable years beginning after December 31, 1979.

RATIONALE FOR AMENDING SECTION 4941

Applying the strict letter of § 4941 to the Hormel Foundation would produce a result which was not contemplated when Congress enacted the 1969 changes in the self-dealing provisions. As it is presently structured, § 4941 would deprive the Foundation of the ability to protect and preserve the remainder interests in the trusts as contemplated by the grantors when both the Foundation and the trusts were created, even though its application to those peculiar facts fails to advance the original purpose of the 1969 changes.

The Tax Reform Act of 1969 created a new Code section, § 4941, to replace the self-dealing provisions then contained in § 503(b). Prior law had employed an arm's length standard for determining the existence of self-dealing, a subjective standard which, when coupled with disproportionate sanctions, proved largely ineffective. Therefore, according to the Senate Report:

To minimize the need to apply subjective arm's length standards, to avoid the temptation to misuse private foundations for noncharitable purposes, to provide a

more rational relationship between sanctions and improper acts, and to make it more practical to properly enforce the law, the Committee has determined to generally prohibit self-dealing transactions and to provide a variety and graduation of sanctions . . . (Senate Finance Committee Report, H.R. 13270, S. Rep. No. 91-552, 91st Cong. 1st Sess. (1969), 29.)

Among the enumerated categories of self-dealing prohibited by the 1969 Act is the furnishing of goods, services or facilities by a disqualified person to a private foundation, or by a private foundation to a disqualified person. As the Senate Committee Report states, "A self-dealing transaction may occur even though there has been no transfer of property between the foundation and the disqualified person." *Id.* at 29. Such is the situation when a foundation provides a service to a disqualified trust as trustee.

But even while these general categories of abuse were recognized by the 1969 Act, Congress realized that there were at least some types of transactions in these categories which carried either so little potential for abuse, or, when the new rules were strictly applied, imposed such a hardship, as to require exception from the general rule. In fact, Congress exempted split-interest trusts created prior to May 27, 1969 from the general requirement of the Act that they be restricted in the same manner as private foundations. Treas. Reg. 53.4947-1(c)(5)(1976). Twenty of the Hormel trusts are split-interest trusts, i.e., trusts having both charitable and non-charitable beneficiaries, and are therefore exempt from *inter alia,* self-dealing restrictions, because the trusts were created prior to May 27, 1969.

Similarly, split-interest trusts are exempted from the stock ownership and speculative investment requirements applicable to private foundations under certain circumstances and regardless of when created, because, as noted by the Senate Finance Committee: . . . the interest of charity in the trust property is not substantial enough in relation to the interests of the noncharitable beneficiaries to warrant the imposition of restrictions on the trust's investments. In other words, since it is unlikely that the use of a nonexempt trust in these situations would give rise to the problems of conflict of interest and diversion of attention from the interests of charity to which these restrictions and requirements are directed, it does not appear appropriate to apply them in these cases. (Senate Report No. 91-552 91st Cong. 1st Sess. ——(1969).)

One of the circumstances justifiying the exemption is, as here, where the charitable interest is a remainder interest.

Therefore the 1969 Act clearly established a policy precedent for the action requested by the Hormel Foundation today. It chose to exclude from the prohibitions trust arrangements created prior to 1969, and chose to exclude from certain restrictions trust arrangements where the interest of the foundation was only a remainder interest. Yet, while excluding those trust arrangements, because of inequitable results and little likelihood for abuse, Congress was not confronted with the same problems when viewed from the perspective of the Foundation. Had Congress been faced with this problem, we believe it would have been addressed in the same manner as spilt-interest trusts.

However, under present law, the curious result is that while the twenty trusts would not be engaging in acts of self-dealing by receiving trust services from the Foundation (because it bears so little potential for abuse), the Foundation is precluded from providing the services because *it* would be self-dealing when viewed from its perspective. We do not believe this curious result was either intended or necessary.

The legislation sought by the Hormel Foundation is not even as broad as the exemption granted to split-interest trusts. Undoubtedly, a blanket exclusion from the self-dealing prohibitions would open the door to widespread potential for abuse. But neither the logic nor the reason underlying the application of the self-dealing requirements to private foundations with respect to disqualified trusts, and the exemptions provided to those rules, justifies their application to the Hormel Foundation in this case. To the contrary, a narrow exception to those requirements, permitting a foundation to serve as trustee for a trust in which it has a beneficial interest and where the trust was irrevocable prior to October 9, 1969, has little potential for abuse and substantial precedent in prior Committee action.

It is conceivable that denying exemption from self-dealing rules to such trusts, while permitting them exemption from other requirements, was due to the range of abuse which such a broad exemption could imply. This is particularly true in light of the fact that self-dealing requirements were contained in the law prior to 1969 and a blanket exclusion could be employed to obtain even more lenient treatment than may have existed before. At the same time, it is equally plausible that the Committees were neither confronted by the trustee question, nor presented with a

limited exception. Indeed, the problem had not existed with respect to such arrangements, since they had been consistently approved by IRS.

The proposed Bill permits a very limited exception to the self-dealing prohibitions which is consistent with existing exceptions. Similar to activities presently exempted, the Hormel Foundation serves as trustees pursuant to an irrevocable instrument wh'ch was binding long before enactment of the 1969 changes and which was, at the time it was entered, consistent with the self-dealing prohibitions. Thus, there is neither the potential for a transaction entered into for purposes of taking advantage of the exception, nor a liberalization of prior law. Further, there is even less likelihood (than with respect to other transactions presently exempted) that rendering services as a trustee would impair the foundation or provide an undue advantage to a disqualified person. This is true because of the fiduciary standards imposed by state law in the administration of the trusts and the competing interests of the life tenants remaindermen which render the transaction one of arm's length.

The proposed bill does, however, suggest two possible liberalizations of existing exemption standards for which we believe the Subcommittee must be given substantial justification. We feel such justification is present in the Hormel Foundation case.

Each of the present exemptions requires that the exempted activity be conducted on terms as favorable as such activity is conducted with the general public. The regulations have interpreted this requirement to mandate the service to be offered to the general public and to be substantially related to the foundation's charitable purpose. We believe these requirements to be both necessary and reasonable. IRS has ruled that the Hormel Foundation does not offer its services as trustee to the general public and that, even if it were to offer such services, they would not be substantially related to its charitable purpose.

The requirement that services be made available to the general public is, of course, necessary to insure that services are not selectively provided to disqualified persons, by establishing an objective standard to insure the neutral effect of the exempted transaction. However, as previously noted, Minnesota law forbids the Foundation to act as trustee in circumstances other than those most likely involving a disqualified person. Failure to offer such service generally does not, therefore, result from the Foundation's attempt to provide a service solely for the benefit of disqualified persons, but from a wholly unrelated restriction forbidding it to do otherwise. The effect of state law should not be a bar to the Hormel Foundation in this instance, particularly since the law supports rather than hinders the purposes of the 1969 amendments by restricting noncharitable activities to those areas in which there is a charitable benefit to be derived.

The Foundation's bill proposes an enforcement alternative, permitting it to provide such services to the disqualified trust on such terms and conditions as the Internal Revenue Service determine are reasonable, based upon all of the facts and circumstances. While this standard lacks some of the objectivity which the 1969 Act has introduced, there is ample precedent for the standard, and, because it would apply, at most, in only a few instances, no significant administrative burden would be imposed on IRS.

The remaining alteration of existing rules pertains to moderating the requirement that the exempted activity be substantially related to an exempt purpose of the Foundation. The Service has concluded that service as a trustee under Hormel's circumstances does not substantially relate to an exempt purpose. The Bill would exempt the activity despite the adverse ruling and, therefore, would have the effect of moderating an existing rule. Again, while the Foundation does not wish to subvert the strictures of present law, but rather only to obtain relief from what we believe to be an unintended result, we feel such a moderation to be justified under the peculiar circumstances presented by the Hormel case.

The Hormel Foundation may act as trustee only for a trust in which it holds a beneficial interest. As trustee, the fiduciary duty runs both to the life tenants and the remainderman, i.e., the Foundation. Upon termination of the life estate, the Foundation will be the recipient of the rewards of its sound trusteeship which may then be employed in its various charitable activities. Certainly, this more than indirectly furthers the charitable purpose of the Foundation, and, at the least, as much as other presently exempted activities. Further, providing such services to those trusts, the grantors of which have chosen to benefit the Foundation with a beneficial interest—and only those trusts—provided a strong inducement to making such contributions, thereby substantially furthering the charitable purposes for which the Foundation was organized. This was, of course, the rationale underlying the Minnesota law.

Under the particular circumstances of the Hormel case, the provision of services as trustee on a reasonable basis to a trust whose grantors have given the Foundation a beneficial interest and a charitable mandate, substantially supports and furthers its exempt purpose.

CONCLUSION

The Hormel Foundation respectfully urges the Committee to adopt S. 1190. The bill is consistent with other exemptions to the self-dealing prohibitions for binding legal relationships existing prior to 1969 and provides concommitant safeguards against the type of abuse which the 1969 changes envisioned. The Hormel Foundation is as deserving of the same exemption with respect to its then-existing binding legal relationships as those previously granted, and believes that had the respective committees, the Congress, and the Foundation known of the effect of the recent IRS interpretation, such an exemption would have originally been sought and granted.

APPENDIX A.—THE HORMEL FOUNDATION

(A) The Foundation, as trustee of Jay C. Hormel Trust No. 1 (which is an inter vivos trust created by Jay C. Hormel on July 16, 1934), and as trustee of Jay C. Hormel Trusts Nos. 101, 102, 103, 201, 202, 203, 301, 302, 303 (which are inter vivos trusts created by Jay C. Hormel on December 26, 1950), holds 1,744,840 shares or 36.32 percent of the total outstanding common stock. Jay C. Hormel died on August 30, 1954. The income from these trusts is payable to the wife and descendants of Jay C. Hormel for life and such income is fully taxable when received by the beneficiaries as in the case of any other private trusts. There is absolutely no tax avoidance. Upon the death of said wife and descendants all of said stock becomes the absolute property of The Hormel Foundation.

(B) The Foundation, as trustee of Geo. A. Hormel Trusts Nos. 3, 4, 5 and 6 (which are inter vivos trusts created by Geo. A. Hormel on October 20, 1934), holds 36,960 shares, and as trustee of a trust created under the Last Will and Testament of Jay C. Hormel, holds 45,692 shares, or a total of 82,652 shares or 1.719 percent of the total outstanding common stock. The income from these Geo. A. Hormel trusts is payable to the wife and sons of Jay C. Hormel for life; the income from this Jay C. Hormel trust is payable to a sister-in-law of Jay C. Hormel for her life; the income is fully taxable when received by the beneficiaries as in the case of any other private trusts. There is absolutely no tax avoidance. Upon the death of said beneficiaries, all of said stock becomes the absolute property of The Hormel Foundation.

(C) Upon the deaths of the above-mentioned life income beneficiaries the Foundation will own absolutely 1,919,029 shares or 39.95 percent of the total outstanding stock of the Hormel Company.

(D) The Foundation, as trustee of Geo. A. Hormel Trusts Nos. 13 and 14, which are inter vivos trusts created on December 23, 1943, and Lillian B. Hormel Trusts Nos. 1 and 2 which are inter vivos trusts created on February 19, 1946, and the trust created under the Last Will and Testament of Lillian B. Hormel dated February 19, 1946, holds 238,527 shares or 4.96 percent of the total outstanding common stock of the Hormel Company, The life beneficiary of these trusts is Germaine D. Hormel, Widow of Jay C. Hormel. Upon her death the total stock will be distributed to the descendants of Jay C. Hormel. These trust are fully taxable. The Foundation will receive no ownership in these shares.

APPENDIX B

DEPARTMENT OF THE TREASURY,
INTERNAL REVENUE SERVICE,
Washington, D.C., September 14, 1971.

Mr. RAYMOND B. ONDOV,
The Hormel Foundation,
Austin, Minn.

GENTLEMEN: We have considered your request for a ruling that certain acts of the Foundation will not be treated as acts of self-dealing described in section 4941(d)(1) of the Internal Revenue Code.

You were recognized as exempt from Federal income tax under the predecessor of section 501(c)(3) of the Code on April 21, 1943. In addition to the performance of your charitable and educational activities, you serve as trustee for 21 irrevocable trusts created by your founder, George A. Hormel, his wife, Lillian B. Hormel, and their only child, Jay C. Hormel. All of these trusts were irrevocable by August 30, 1954.

In 19 of the 21 trusts the income beneficiaries are disqualified persons, and in the remaining trusts, the income beneficiaries are not disqualified persons with respect to the Hormel Foundation. In 14 of the 19 trusts having disqualified persons as income beneficiaries, you have a vested remainder interest. In the other five trusts you have a contingent remainder interest. You have never charged a separate trustee's fee against said trusts. However, you have always been reimbursed by said trusts for any moneys expended by you which are incurred in the administration of the trusts.

You do not comingle the funds of the trusts with your own funds. Separate and complete accounts and records are maintained for your own assets and for the funds which you administer for the trusts. No charitable funds are expended or used for the benefit of the trusts.

You have requested a ruling that assuming the administration of the trusts constitutes self-dealing under section 4941 of the Code, that section 101(1)(2)(D) of the Tax Reform Act of 1969 is applicable.

Section 101(1)(2)(D) provides that section 4941 of the Code shall not apply to the use of goods, services, or facilities which are shared by a private foundation and a disqualified person until taxable years beginning after December 31, 1979, if such use is pursuant to an arrangement in effect before October 9, 1969, and such arrangement was not a prohibited transaction, within the meaning of section 503(b), at the time it was made and would not be a prohibited transaction if such section continued to apply.

Serving as trustee for the 19 trusts in which both you and disqualified persons have an interest constitutes the shared use of goods, services, or facilities pursuant to an arrangement in effect before October 9, 1969, that was not a prohibited transaction (within the meaning of 503(b)) at the it was made and would not be a prohibited transaction if such section continued to apply. Therefore, section 4941 of the Code shall not apply to such activities for taxable years beginning before December 31, 1979.

We are advising the District Director, St. Paul, Minnesota, which is your key district for exempt organization matters of our ruling.

Thank you for your cooperation.

Sincerely yours,

LINDER HAMBLEN,
Director, Miscellaneous and Special Provisions Tax Division.

APPENDIX C

DEPARTMENT OF THE TREASURY,
INTERNAL REVENUE SERVICE,
Washington, D.C., July 29, 1977.

Mr. RAYMOND B. ONDOV,
Austin, Minn.

DEAR MR. ONDOV: The enclosed copy of a ruling letter is sent to you under the provisions of a power of attorney you have on file with us.

Sincerely yours,

MILTON CERNY,
Chief, Rulings Section 2, Exempt Organizations, Technical Branch.

Enclosure.

DEPARTMENT OF THE TREASURY,
INTERNAL REVENUE SERVICE,
Washington, D.C. July 29, 1977.

The HORMEL FOUNDATION,
Austin, Minn.

LADIES AND GENTLEMEN: This is in reply to your letter of September 30, 1976, in which you requested a ruling concerning the application of section 4941 of the Internal Revenue Code of 1954.

The information indicates that the foundation serves as trustee for nineteen irrevocable trusts, in which the income beneficiaries are disqualified persons with respect to the foundation. In fourteen of the trusts, The Hormel Foundation is the vested remainderman, and in five of the trusts, the foundation is the contingent remainderman.

The trusts reimburse the foundation for one-half of the foundation's directors' fees and for expenditures incurred in the administration of the trusts. No other charges are made to the trusts.

The foundation administers and has administered in the past a limited number of annuity bond funds and life income gifts for individuals, none of whom are disqualified persons. No charges are made to these funds other than the expenses of operation and administration. Minnesota law prohibits a nonprofit corporation such as The Hormel Foundation to act as trustee for a private trust unless the corporation is given an interest in the trust assets.

In a ruling dated September 14, 1971, the Internal Revenue Service concluded that, under section 101(l)(2)(D) of the Code (now section 53.4941(d)-4(d) of the regulations), the foundation would not be subject to taxes under section 4941 of the Code before December 31, 1979.

A conference was held at the Internal Revenue Service National Office in Washington, D.C. on December 16, 1976.

Section 4941(d)(1)(C) of the Code provides that the term "self-dealing" means any direct or indirect furnishing of goods, services, or facilities between a private foundation and a disqualified person.

Section 4946(a)(1)(G) of the code provides that a disqualified person includes a trust in which members of the family of a substantial contributor to the foundation own more than 35% of the total beneficial interest.

Section 4941(d)(2)(D) of the Code provides that the funishing of goods, services, or facilities by a disqualified person to a private foundation shall not be an act of self-dealing if such furnishing is made on a basis no more favorable than that on which such goods, services, or facilities are made available to the general public.

Section 53.4941(d)-3(b)(2) of the foundation Excise Tax regulations provides that the term "general public" shall include those persons who, because of the particular nature of the activities of the private foundation, would be reasonably expected to utilize such goods, services, or facilities. This paragraph shall not apply, however, unless there is a substantial number of persons other than disqualified persons who are actually utilizing such goods, services or facilities.

Section 53.4941(d)-3(b)(1) of the regulations provides that section 4941(d)(2)(D) of the Code shall not apply in the case of goods, services, or facilities furnished later than May, 1973, unless such goods, services, or facilities are functionally related, within the meaning of section 4942(j)(5), to the exercise or performance by a private foundation of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(c)(3).

Section 4942(j)(5)(B) of the Code defines the term "functionally related business" to mean

(A) A trade or business which is not an unrelated trade or business (as defined in section 513), or

(B) An activity which is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which is related (aside from the need of the organization for income or funds or the use it makes of the profit derived) to the exempt purposes of the organization. See also section 53.494(a)-2(c)(3)(iii)(a) of the regulations.

Section 513 of the Code defines the term "unrelated trade or business" to mean, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.

Section 53.4942(a)-2(c)(3)(iii)(b) of the regulations illustrates the meaning of "functionally related" with two examples:

Example (1).—X, a private foundation, maintains a community of historic value which is open to the general public. For the convenience of the public, X, through a wholly owned, separately incorporated, taxable entitiy, maintains a restaurant and hotel in such community. Such facilities are within the larger aggregate of activities which makes available for public enjoyment the various buildings of historic interest and which is related to X's exempt purpose. Thus, the operation of the restaurant and hotel under such circumstances constitutes a functionally related business.

Example (2).—Y, a private foundation, as part of its medical research program under section 501(c)(3), publishes a medical journal in carrying out its exempt purposes. Space in the journal is sold for commercial advertising. Notwithstanding the fact that the advertising activity may be subject to the tax imposed by section 511, such activity is within a larger complex of endeavors which makes available to the scientific community and the general public developments with respect to medical research and is therefore a functionally related business.

Section 4947(a)(2)(C) of the Code provides that in the case of a trust which is not exempt from tax under section 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and

which has amounts in trust for which a deduction was allowed under certain sections of the Code, section 4941 shall not apply to any amounts transferred in trust before May 27, 1969.

The Hormel Foundation is not a non-exempt charitable trust, but is an exempt organization under section 501(c)(3) of the Code. Because the foundation may only make grants to charitable organizations exempt under section 501(c)(3) of the Code, all of its unexpired interests are devoted to purposes described in section 170(c)(2)(B) of the Code. Therefore, section 4947(a)(2)(C) of the Code does not apply to The Hormel Foundation.

If the income beneficiary of each of the nineteen trusts owns more than 35 percent of the total beneficial interest in each trust, then the nineteen trusts are disqualified persons with respect to The Hormel Foundation. Section 4946(a)(1)(G) of the Code. By acting as trustee for the trusts, the foundation is furnishing services to disqualified persons.

While the foundation provides the same services to some annuity bond funds and life income gifts, none of which benefit disqualified persons, the number of such funds and gifts is not substantial. The general public would not ordinarily be expected to utilize the kinds of services the foundation provides, particularly since Minnesota law precludes the general public from making use of such services. Section 53.4941(d)-3(b)(2) of the regulations. Therefore, the foundation's services are not available to the general public. Section 4941(d)(2)(D) of the Code.

Even if the foundation's services were offered to the general public, such services are not "functionally related" to the foundation's other activities and endeavors. Section 53.4941-(d)3(b)(1) of the regulations. The services are an unrelated trade or business because they are not substantially related to the exercise or performance of the foundation's exempt purpose. Acting as trustee for trusts does not further the exempt purposes of the foundation, but simply contributes to the foundation's fund-raising activities. Section 513 of the Code. Section 4942(j)(5)(B) of the Code. The foundation's services are not offered for the convenience of the public, nor do they make available to the public results of any research. Examples (1) and (2) of section 53.4942(a)-(2)(C)(3)(iii)(b) of the regulations.

We conclude that, if the trusts are disqualified persons with respect to The Hormel Foundation, the foundation's services of acting as trustee for nineteen irrevocable trusts, the income beneficiaries of which are disqualified persons, constitutes self-dealing within the meaning of section 4941(d)(1)(C) of the Code.

If the income beneficiary of each of the nineteen irrevocable trusts does not own more than 35 percent of the total beneficial interest in each trust, then the nineteen trusts are not disqualified persons with respect to The Hormel Foundation. If the trusts are not disqualified persons, we conclude that the foundation's services of acting as trustee for the nineteen trusts does not constitute self-dealing within the meaning of section 4941(d)(1)(C) of the Code.

Your District Director, St. Paul, Minnesota, is being advised of this action.

Sincerely yours,

MILTON CERNY,
Chief, Rulings Section 2,
Exempt Organizations, Technical Branch.

STATE OF MINNESOTA,
OFFICE OF THE ATTORNEY GENERAL,
St. Paul, July 26, 1979.

Re The Hormel Foundation and H.R. 2173.

HOWARD WEINMAN, Esq.,
Joint Committee on Taxation,
Longworth House Office Washington, D.C.

DEAR MR. WEINMAN: There is currently before Congress a bill (H.R. 2173) to amend the Tax Reform Act of 1969 so as to permit the Hormel Foundation of Austin, Minnesota, to continue as trustee of certain split-interest trusts. You recently inquired about certain aspects of Minnesota trust law which might bear upon the proposed legislation.

The Hormel Foundation is the trustee of nineteen split-interest trusts, the income of which is payable to descendants of George A. Hormel, and in each of which the Hormel Foundation has a vested or contingent remainder interest. Together, these trusts contain a controlling interest in the George A. Hormel Company, the principal employer in Austin. The United States Internal Revenue Service has concluded that the Hormel Foundation will be engaged in a prohibited act of self-dealing,

under 26 U.S.C. § 4941, if the Foundation continues to serve as trustee of these trusts after December 31, 1979. H.R. 2173 would amend § 4941 and effectively authorize the Foundation to remain as trustee for an additional ten years.

It is my understanding that the Department of the Treasury opposes H.R. 2173, in part on the ground that the Foundation should avail itself of possible judicial relief—*i.e.*, seek to resign as trustee of the trusts—before seeking special legislation. You have asked whether, under Minnestoa law, there is any obstacle to such a resignation.

In trust proceedings, as you know, wide discretion is vested in the presiding judge. This is particularly true with regard to the resignation of a trustee. To resign, a trustee must offer a reasonable basis for his resignation, and he must obtain the approval of the court. Minn. Stat. § 501.42 (1978). Beyond this, it is impossible to say much about what will constitute adequate cause in a particular case.

The Hormel Foundation contends that a Minnesota court would not authorize the Foundation to resign, because such a resignation would defeat the intentions of the settlors of the trusts. The settlors, members of the Hormel family, intended that the Foundation as trustee of the trusts, would control the Hormel Company and operate it for the betterment of the area in which it is located. However, this obligation is set forth in the by-laws of the Foundation and does not appear in the instruments governing the trusts themselves. For this reason, the Foundation argues, any successor trustee would not be bound by the duty to retain control of the Company, and the purposes of the settlors would be frustrated.

The discretion of the presiding court is simply too great to permit meaningful conjecture whether this possiblity would preclude resignation by the Foundation. The issue would be complicated by the question whether the settlors' intentions are compatible with the policies underlying the Tax Reform Act of 1969, and by the additional question whether the trust instruments might be construed so as to incorporate the duty to retain control of the Company, thus obligating a successor trustee to effectuate the settlors' plan.

In any event, questions concerning a voluntary resignation may well be moot. Mr. Raymond Ondov, attorney for the Foundation and a member of its board of directors, has informed me that the Foundation would consider resignation an abdication of its fiduciary duty, because resignation would defeat the intention of the settlors and because the Foundation does not consider the issue to be ripe for adjudication. Accordingly, the Foundation would resign only under compulsion.

Thus, the possibility of judicial relief would not arise upon the trustee's petition to resign, but only upon a petition (*e.g.*, of a beneficiary, or of this office) to remove the Foundation as trustee. While this office cannot, under Minnesota statutes, offer a legal opinion as to the outcome of such a proceeding, it is possible to observe that removal of a trustee is an extraordinary remedy, and is not often granted in the absence of clear evidence of a material breach of fiduciary duty. Although a clear violation of the self-dealing prohibitions of 26 U.S.C. § 4941, or the parallel provisions of Minn. Stat. §§ 317.165(2) and 501.115(b) (1978) would be a potential basis for removal, it is doubtful whether a letter ruling of the I.R.S. would be sufficiently final or conclusive to establish a violation. Under these circumstances, it appears unlikely that the Foundation would be removed involuntarily.

This office takes no position with regard to the merits of H.R. 2173. We do point out that, aside from the questions you have raised, the bill appears to present the broad policy question whether Congress intends to prevent a charitable foundation from controlling a non-charitable corporation for the benefit of a particular community.

It may be that this issue was conclusively resolved by the enactment of the Tax Reform Act of 1969, with its excess business holdings provisions, but H.R. 2173 does appear to raise the issue, and we simply call it to the Committee's attention.

Sincerely yours,

D. DOUGLAS BLANKE,
Special Assistant,
Attorney General.

NATIONAL MILK PRODUCERS FEDERATION,
Washington, D.C., November 8, 1979.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: This statement is submitted in response to the Committee on Finance notice of October 16 regarding hearings by its Subcommittee on Taxation and Debt Management on the Technical Corrections Act of 1979.

The National Milk Producers Federation is a farm commodity organization representing nearly all of the several hundred dairy marketing cooperatives serving their dairy farmer members and the nation's consumers. As such it is interested in any changes in tax law which directly affects these cooperatives or the nation's dairy farmers.

We are therefore concerned about the application of the alternate mimimum tax for taxpayers other than corporations as found in Section 421 of P.L. 95-600.

The conference report on this tax would indicate that it is intended to apply against preferential income items. The explanation of the House bill (p. 263) state: "The House bill removes capital gains as an item of tax preferences subject to the existing 15-percent minimum tax. However, the bill provides for the imposition of an alternative minimum tax."

In discussing the Senate amendment the conference report (p. 264) indicates: "In general the preferences for purposes of the new alternative minimum tax are the same as under present law."

While the intent of this new section of the law may have been to have it apply to preference income items it is written so that it can apply to ordinary income (i.e. income from other than preferential sources) over $20,000, if there are offsets as investment credit, either current or carried over. We do not believe this was the intent of this legislation. We also believe this can be corrected by a very minor change.

Our concern arises because of the impact this section of Public Law 95-600 could have on farmers, most of whom operate as self-employed (unincorporated) entities and who in many instances will have investment credits to apply against their 1979 tax.

The new Section 55 of the law requires the imposition of the alternate tax to the extent that it exceeds the individual's regular tax after various credits have been applied.

To illustrate our point: Assume a farmer has a taxable income for 1979 of $25,000, all of which is from his self-employed farming operation and none of which is from capital gains or other preference items. Assume also that he has investment credits (either current or carried forward) more than sufficient to offset his regular tax. His regular tax, therefore, is zero. His alternative minimum tax is $500 (($25,000 − $20,000) × 10 percent). He will owe this even though he has had no preference income items.

It is recognized that the reduction of the regular tax may also occur through the use of non-refundable credits other than investment credit. We have focused on the latter, however, because, in addition to its being the most applicable of the credits to the farmers we represent, the use of the inveatment has been considerably extended by Public Law 95-600. Yet to the extent that it applies in the above illustration the computation of the $500 tax is the direct result of the use of this investment credit, while no such computation would be made if there had been no such credit. To that extent the benefits to the taxpayer of the investment tax credit are nullified.

If it was the intent of the committee to fundamentally have this alternate tax apply against preference income items it is our belief that this can be readily corrected without losing the intent, or the impact, of the alternate minimum tax. It is suggested that this tax be computed against the regular tax before the credits are taken, rather than after. The provision that nonrefundable credits not apply against the extra tax determined by the alternate method could be retained.

Sincerely,

PATRICK B. HEALY, *Secretary.*

HEDRICK AND LANE,
Washington, D.C. November 14, 1979.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: Transmitted herewith are five copies of a statement covering a proposed amendment to Section 401(k) of the Code to cover money purchase pension plans.

Please include the statement in the record of the November 7, 1979 hearings on the Technical Corrections Act of 1979.

Respectfully submitted,

WARREN ELLIOTT.

Enclosures.

SECTION 401(K) OF THE INTERNAL REVENUE CODE SHOULD BE AMENDED TO COVER MONEY PURCHASE PENSION PLANS

There are several hundred qualified money purchase pension plans covering thousands of employees which have been in existence for several years. These plans are also known as "salary reduction" plans. Many of these plans will have to be terminated as of January 1, 1980 because of the effect of Section 401(k) of the Internal Revenue Code.

Section 401(k) of the Code, added by Section 135 of the Revenue Act of 1978, delineates certain standards which, if met by a qualified cash or deferred profit sharing or stock bonus plan, permit the establishment and maintenance of such plans. it is theoretically possible to convert money purchase pension plans into qualified cash or deferred arrangements which satisfy Section 401(k) of the Code. However, it is believed that termination, rather than conversion, will occur. These plans were, in large part, established by marginal employers who could not afford the cost of establishing and maintaining a standard qualified plan but who wished to provide their employees with an opportunity for retirement savings. Given the current regulatory climate and the impact of plan changes on this group of predominantly small employers, it is believed that a large number of these employers would elect to terminate their plans rather than go through a conversion process. This would be adverse to the interests of plan participants and clearly inconsistent with the public policy expressed in ERISA of encouraging the growth of effective retirement savings plans.

Failure to include qualified money purchase pension plans as an accepted form of cash or deferred arrangement under Section 401(k) of the Code is believed to have been an oversight produced by the hurried effort to enact tax legislation in the autumn of 1978 (the policy concerns over these arrangements, described by the Congress during the enactment of ERISA, have been allayed by the nondiscrimination and other requirements imposed by Section 401(k) on profit sharing and stock bonus plans). This oversight has resulted in unjustifiable statutory distinctions between different types of qualified plans. It should be remedied as soon as possible so that participants in existing money purchase pension plans may enjoy the same status as participants in profit sharing and stock bonus plans under the Revenue Act of 1978. Appropriate legislative action will prevent the untimely termination of hundreds of affected money purchase pension plans benefiting thousands of employees.

Accordingly, we recommend enactment of the attached amendment.

AMENDING SECTION 401(K) OF THE INTERNAL REVENUE CODE TO COVER MONEY PURCHASE PENSION PLANS

The attached amendment extends coverage under Section 401(k) of the Code to cash or deferred arrangements in the nature of money purchase pension plans which were in existence on November 19, 1979.

Under the amendment, covered money purchase pension plans are to be subject to the requirements and standards of Section 401(k) which apply to other forms of cash or deferred arrangements, including the limitations on distributions and the participation and discrimination standards. Amounts of salary reduction are to be treated as employer contributions. In addition, for money purchase pension plans the election to defer must be with respect to an amount which does not exceed 10 percent of the employee's compensation for the plan year. This additional requirement is designed to assure that lower paid employees will be able to afford to participate in

the plan if they so desire. Plans covered by the amendment will be permitted to enroll new participants.

This amendment remedies an oversight which occurred during the enactment of Section 401(k) (in the Revenue Act of 1978) when the money-purchase type of cash or deferred arrangement was inadvertently overlooked.

[Attachment]

PROPOSED AMENDMENT

Paragraph (1) of Section 401(k) is amended to read as follows:

A profit sharing or stock bonus plan, or a money purchase pension plan which was in existence on November 19, 1979, shall not be considered as not satisfying the requirements of subsection (a) merely because the plan includes a qualified cash or deferred arrangement.

Paragraph (2) of Section 401(k) is amended to read as follows:

A qualified cash or deferred arrangement is any arrangement that is part of a profit sharing, stock bonus, or money purchase pension plan which meets the requirements of subsection (a)—

(A) under which a covered employee may elect to have the employer make payments as contributions to a trust under the plan on behalf of the employee, or to the employee directly in cash (in the case of a money purchase pension plan, in which amounts of salary reduction are to be treated as employer contributions, not more than 10 percent of the employee's compensation for the plan year may be subject to such an election); . . .

NATIONAL COUNCIL OF FARMER COOPERATIVES,
Washington, D.C., November 14, 1979.

Re Technical Corrections Act of 1979 (H.R. 2797)—Rules for New Jobs Credit for Cooperatives—Section 52(h) of the Internal Revenue Code.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Senate Finance Committee, Dirksen Senate Office Building, Washington, D.C.

DEAR CHAIRMAN BYRD: The National Council of Farmer Cooperatives wishes to call the Subcommittee's attention to an omission in the Technical Corrections Act of 1979 relating to the availability of new jobs credit for cooperatives.

The Technical Corrections Act of 1979 as passed by the House on July 16, 1979 contains a provision designed to allow any WIN or jobs credits of a cooperative to be determined in the same way that investment tax credits are determined under the amendment contained in the Revenue Act of 1978. Prior to the amendment, special rules applied to cooperatives for purposes of determining the amounts of investment credit, WIN credit, and jobs credit available to them. The 1978 Act revised the rules pertaining to investment credit for cooperatives by removing the reference to cooperatives formerly found in Section 46(e) of the Code, and by creating a new Section 46(h) which provides for pass through of unused credits by the cooperative to its patrons. These new rules apply to taxable years ending after October 31, 1978.

The House Ways and Means Committee Report on H.R. 2797 explained the reasons for the technical amendment relating to cooperative WIN and jobs credits as follows:

While the Act revised the rules pertaining to the investment credit for cooperatives, no change was made in the rules pertaining to the WIN and jobs tax credits for cooperatives. The Congress intended that the rules for determining the amounts of WIN and jobs credits for cooperatives should be the *same* as the new rules for determining the amount of investment credit for cooperatives. (Emphasis supplied.)

In order to implement the intent of the technical amendment, three sections of the Internal Revenue Code require modification, namely Section 50B(f) (WIN credit), Section 52(f) (targeted jobs credit), and Section 52(h) (new jobs credit). However, the amending language of H.R. 2797 presently states that only Sections 50B(f) (WIN credit) and 52(f) (targeted jobs credit) are each amended by striking out "section 46(e)" and inserting in lieu thereof "subsections (e) and (h) of section 46." Inexplicably, no reference is made to the third provision, Section 52(h) (new jobs credit).

The new investment tax credit rules for cooperatives apply to tax years *ending* after October 31, 1978. For example, a cooperative whose tax year ends November 1, 1978 or later is entitled to claim investment tax credits for any qualified property placed in service during the previous twelve months. We believe the Ways and Means Committee clearly intended that jobs credits available under Section 52(h) be

treated in the same manner. That is, jobs credits earned in a taxable year ending after October 31, 1978 should be fully available on the same basis as investment tax credits.

In view of the declared intent of Congress to conform the WIN and jobs credits of cooperatives to the newly enacted investment credit rules, and the above-mentioned explanation contained in the Ways and Means Committee Report, it seems clear that failure to include Section 52(h) in the amending language was merely an oversight.

Therefore, the National Council urges the inclusion of Section 52(h) in the amendment related to Section 316 of the Revenue Act of 1978. The amendment would then read as follows:

(4) *Amendment Related to Section 316 of the Act.*

Sections 50B(f), 52(f) and 52(h) are each amended by striking out "section 46(e)" and inserting in lieu thereof "subsections (e) and (h) of section 46."

The National Council appreciates this opportunity to submit its views on H.R. 2797.

Sincerely,

JAMES S. KRZYMINSKI,
Associate General Counsel.

LAW OFFICES OF PAUL H. DELANEY, Jr.,
Washington, D.C., November 9, 1979.

Hon. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: In accordance with the Press Release of the Subcommittee on Taxation and Debt Management of the Committee on Finance (sometimes hereinafter referred to as the "Subcommittee") of October 16, 1979 regarding the Subcommittee's public hearings on the Technical Corrections Act of 1979, we request that the enclosed memorandum, submitted on behalf of Cargill Leasing Corporation, be made a part of the record of the Subcommittee's hearings.

As requested in the Subcommittee's Press Release, we wish to confirm our support for Section 102(a)(1)(D) of the House Bill concerning an exception for substantial leasing activities.

More specifically, the House Ways and Means Committee report on H.R. 2979, the Technical Corrections Act of 1979, relates the following with respect to privately held firms engaged in substantial equipment leasing: [1]

"d. Waiver of controlled group rule where there is substantial leasing activity (sec. 102(a)(1)(D) of the bill and sec. 465 (c) of the Code.)

PRESENT LAW

Prior to the Revenue Act of 1978, the only types of corporations to which the at risk rules (sec. 465) applied where subchapter S corporations and personal holding companies. The Act extended the application of the at risk rules to certain closely held corporations (even though they would not qualify as personal holding companies and had not made subchapter S elections). However, the Act contains an exception to the at risk limitations for closely held corporations actively engaged in equipment leasing operations. To qualify for this exception, more than 50 percent of a corporation's gross receipts must be derived from equipment leasing. In order to prevent abuse, the Act provided that the 50 percent test is to be applied to the total gross receipts of all the members of a controlled group of corporations.

REASONS FOR CHANGE

The Act applies the at risk limitations to a number of substantial active equipment leasing operations. This has occurred because the gross receipts from equipment leasing of some members of a controlled group of corporations, while substantial in an absolute sense, constitute less than 50 percent of the total gross receipts of all the members of the controlled group. *In many of these situations, some of the corporations in the group have significant active leasing activities (as measured by employees, receipts, and number of transactions). The committee concluded that members of a closely held controlled group of corporations which are substantially*

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[1] See Report of the Committee on Ways and Means, United States House of Representatives on H.R. 2797, 96th Cong., 1st Sess., pp. 33 and 34, June 7, 1979.

involved in equipment leasing should be exempted from the at risk rules. [Emphasis supplied.]

EXPLANATION OF PROVISION

Under the bill, if certain tests are met, the leasing gross receipts percentage requirement is not to be applied to the total gross receipts of the controlled group.[2] Instead, the gross receipts requirement, increased to 80 percent, is to be applied separately to each member corporation of the controlled group.

The provisions of the amendment are applied to the quantum of certain activities of the "qualified leasing members" of the controlled group of corporations. A corporation is a qualified leasing member if in the current and each of the immediately preceding two taxable years (1) it is a component member of the controlled group of corporations, and (2) 80 percent or more of its gross receipts is attributable to equipment leasing.

The controlled group 50 percent requirement would be waived, and instead, an 80 percent gross receipt corporation-by-corporation requirement would apply, if the qualified leasing members (if any) meet the following tests for the current and two immediately preceding taxable years:

(1) The controlled group had at least three full time employees, substantially all of the services of whom were directly related to the equipment leasing activities of the qualified leasing members;

(2) the qualified leasing members, in the aggregate, entered into at least five separate equipment leasing transactions;[3] and

(3) the qualified leasing members, in the aggregate, had at least $1,000,000 of equipment leasing gross receipts.

Based on the considerations set forth above, we support the subject provision of the Technical Corrections Act of 1979 as passed by the House.

Thank you very much for your consideration.

Respectfully submitted.

PAUL H. DELANEY, JR.

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[2] Of course, if the controlled group meets the 50 percent gross receipts requirement of section 465(c)(4), this new provision would not apply.

[3] It is contemplated that separate written lease agreements with the same lessee pertaining to items of equipment which are related parts of what is in substance a single lease "package" would be treated as one equipment leasing transaction.

BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE
WASHINGTON, D.C.

APPLYING THE "AT RISK" PROVISIONS OF SECTION 465 TO CARGILL LEASING CORPORATION, A CLOSELY HELD COMPANY ACTIVELY ENGAGED IN EQUIPMENT LEASING; AN ANALYSIS OF THE REVENUE ACT OF 1978 AND TECHNICAL CORRECTIONS ACT OF 1979

INTRODUCTION

The Revenue Act of 1978 amended the "at risk" provisions of Section 465 of the Internal Revenue Code in an attempt to broaden the categories of taxpayers and transactions which would be subject to such provisions. One of the categories of taxpayers generally sought to be covered is closely held corporations. Because the Act provided that the Section 318 stock ownership attribution rules are to be applied in determining whether a corporation is closely held, Cargill Leasing Corporation is not presently subject to the limitations on losses prescribed by the at risk provisions. Section 102(a)(1)(A) of the Technical Corrections Act of 1979 (HR 2797) would, however, substitute the stock ownership attribution rules of Section 544 for the rules of Section 318. If this proposed change becomes law, Cargill Leasing Corporation would become subject to the at risk provisions of the Code while its publicly owned competitors engaged in the same activities would not. The ultimate consequence of this result would be to remove Cargill Leasing Corporation from the leasing business.

Cargill Leasing Corporation does not believe it should be subject to the at risk provisions of Section 465 for the following reasons:

I CARGILL LEASING CORPORATION IS A CORPORATION ACTIVELY ENGAGED IN LEASING EQUIPMENT

II CARGILL LEASING CORPORATION'S ACTIVITIES ARE IDENTICAL TO THE ACTIVITIES OF MANY PUBLICLY OWNED COMPANIES

III CONGRESS HAS RECOGNIZED THE NEED FOR AN EXEMPTION FROM THE AT RISK RULES FOR CLOSELY HELD CORPORATIONS ACTIVELY ENGAGED IN EQUIPMENT LEASING

IV AS A MATTER OF TAX POLICY, THE AT RISK RULES OF SECTION 465 OUGHT NOT TO BE EXTENDED TO CARGILL LEASING CORPORATION

V THERE IS A LEGISLATIVE ALTERNATIVE TO THE PRESENT STATUTORY SCHEME WHICH WOULD EXCLUDE CARGILL LEASING CORPORATION AND OTHER CLOSELY HELD CORPORATIONS ACTIVELY ENGAGED IN EQUIPMENT LEASING AND WOULD CONTINUE TO SUBJECT POSSIBLE TAX ABUSE SITUATIONS TO THE AT RISK RULES

VI THE LEGISLATIVE HISTORY OF THE REVENUE ACT OF 1978 INDICATES THAT AN ACTIVE LEASING CORPORATION WAS NOT INTENDED TO BE SUBJECT TO THE AT RISK RULES

CARGILL LEASING IS A CORPORATION
ACTIVELY ENGAGED IN LEASING EQUIPMENT

Cargill Leasing Corporation, a 100% owned subsidiary of Cargill, Incorporated, was formed in 1973 for the purpose of leasing equipment in what the industry identifies as the middle market. Briefly, that market is Section 38 property with a value of $50M-$500M. It is now and has been Cargill's intention to build an operating unit with outside offices that could administer itself, borrow money for its own account and produce a profit on its audited financial statements. Presently, Cargill Leasing has four offices located in Cincinnati, Milwaukee, Kansas City and Minneapolis and more than twenty employees. For the most recent fiscal year, Cargill Leasing wrote approximately $13MM of lease volume of which $2MM was from leveraged leases. That volume and its existing portfolio generated $575M of net profits after taxes on its operating statements.

Its lease volume, for the most part, is produced by seven marketing personnel calling on equipment vendors and corporate and individual lessees who sell or use equipment common to the following industries:

Agriculture
Transportation
Construction
Production Machine Tools

Cargill Leasing participates in two broad categories of equipment leasing; "nonrecourse leveraged leasing" and "single investor leasing." During the early years of both leases, the tax deductions available to the lessor exceed the rentals and through the filing of a consolidated tax return provide a tax benefit to the Cargill, Incorporated group for which Cargill Leasing is compensated by Cargill, Incorporated. Cargill Leasing currently has about $10 million of equipment on leveraged lease to railroads and trucking lessees. Some of the companies against whom Leasing competes in the leveraged lease market are ITEL Corporation (San Francisco), Matrix Leasing Corporation (a subsidiary of

the First National Bank of Minneapolis), Bank AmeriLease (a subsidiary of the Bank of America) and United States Leasing International.

In a single investor leasing transaction, Cargill Leasing purchases the equipment with internally generated funds and leases it to the lessee under an arrangement constituting a true lease for tax purposes and not a conditional sale. About 75% of Cargill Leasing's portfolio of single investor leases are with small to medium sized farms and businessmen. Cargill Leasing's competitors in this market are local banks, finance companies and small leasing companies.

CARGILL LEASING'S ACTIVITIES ARE IDENTICAL TO THE ACTIVITIES OF MANY PUBLICLY OWNED COMPANIES

Leveraged Leasing

Cargill Leasing engages in an activity known in the industry as "leveraged leasing". The term "leveraged" refers to the fact that the lessor of the equipment borrows a significant percentage of the equipment purchase price from an unrelated lender such as a bank or insurance company. The percentage of the purchase price which is borrowed commonly runs from 60% to 75% and is ordinarily borrowed on a "nonrecourse" basis, i.e., the lender may look only to the equipment to satisfy the debt in the event of default and may not go to the lessor's other assets. Publicly held corporations in the leasing business also borrow on a nonrecourse basis as illustrated by the following quotation from Note 1 to the financial statements contained in the 1978 Annual Report of Westinghouse Credit Corporation:

> "WCC participates in leveraged leasing transactions in which the cost of assets leased to others is financed primarily by loans from debt participants, but ownership of property is retained by WCC and other equity participants. The loans by the debt participants are secured by the lessees' rental obligations and the leased property and are without deficiency liability against WCC and other equity participants."

Because of the large debt associated with a leveraged transaction, a leveraged lease generates large interest payments to lenders and consequent tax deductions. In the early years of the lease the interest deduction and the depreciation deductions combine to create a loss. Since Cargill, Incorporated and Cargill Leasing join in the filing of a consolidated federal tax return, these losses (as well as investment tax credits) provide a tax benefit to the group of companies,

and as permitted by the consolidated return regulations, Cargill makes a payment to Cargill Leasing for this benefit. The timing and amount of these payments are critical to the construction of the lease rate applicable to the equipment. The reason for this is that the lease rate (the amount of the lessee's payment) is based on the rate of return the lessor makes from the transaction and the rate of return is determined by the timing and amount of cash flowing to the lessor. Anything which reduces the amount of cash flow or delays the timing of the payment to the lessor causes the rate of return to decline and a consequent increase in the lease rate. Since Cargill Leasing would be subject to the limitation on losses imposed by the at risk provisions of Section 465, it would have to increase its lease rates to maintain its return. However, since Cargill Leasing's publicly held competition would not be subject to these limitations, their rates would generally be lower. Cargill Leasing would, thus, be placed at a substantial competitive disadvantage. The importance attached to these tax allocation payments from the group's parent is not unique to Cargill Leasing. This fact is illustrated by examining the published financial statements of widely held leasing companies. For example, the 1977 Annual Report of The Greyhound Corporation states at Note I:

> ". . .Greyhound Leasing, as well as other eligible subsidiaries of Greyhound, is included in the consolidated federal income tax returns of Greyhound. As a result, certain amounts of tax losses, investment tax credits and foreign tax credits have been utilizable by Greyhound which could not have been utilized by Greyhound Leasing on a separate return basis. These amounts, aggregating $11,230,000 in 1977 and $17,106,000 in 1976, have not been reflected as a reduction of the provision for federal income taxes currently payable, since the reductions in Greyhound's tax liability have been credited to amounts due to Greyhound Leasing and are paid when realized by Greyhound."

Similar statements may be found in the Annual Reports of Westinghouse Credit Corporation and Ford Motor Credit Company:

". . .WCC is included in the consolidated federal income tax return filed by its parent, Westinghouse Electric Corporation. The allocation to WCC of its portion of the consolidated tax is covered by a tax allocation agreement. As provided in the agreement, the 1978 and 1977 provisions for taxes currently payable (recoverable) represent the effect of WCC's income, deductions and credits on the consolidated tax. The agreement further provides that WCC will receive full tax recovery from Westinghouse Electric Corporation applicable to its deductions and credits whether or not full tax recovery is realized for those deductions and credits in the consolidated federal income tax return filed for the current year." (1978 Annual Report, p. 22, Westinghouse Credit Corporation).

". . .Lease Transactions: Leasing operations consist principally of leasing of various types of data processing equipment, transportation equipment and construction and mining equipment. Such leases are accounted for as direct financing leases or leveraged leases, except for certain data processing equipment leases which are accounted for as operating leases."

". . .Taxes on Income: The Company and its domestic subsidiaries join Ford Motor Company in filing consolidated United States income tax returns. Pursuant to an arrangement with Ford, United States income tax liabilities or credits are allocated to the Company in accordance with the contribution of the Company and its subsidiaries

to Ford's consolidated tax liability. The Company allocates tax liabilities or credits to its subsidiaries in accordance with each subsidiary's contribution to the consolidated tax liability." (1977 Annual Report, p. 11, Ford Motor Credit Company).

Although the legislative history of the Revenue Act of 1978 is more fully examined in Section IV of this paper, the Carter Administration's tax proposals appear to be based on the assertion that there are valid distinctions between publicly held and privately held corporations. Such proposals assume that the two types of companies operate differently and enter into leveraged transactions for different reasons. They further assume that all private companies engaging in leasing are "bad":

"Thus, equipment leasing by a closely held corporation may lead to tax abuse, even though equipment leasing by a widely held corporation is generally a desirably activity." [1]

This broad generalization is not supportable and is incorrect when applied to Cargill Leasing. Cargill Leasing performs the same functions, on the same tax and financial bases, as a publicly held equipment lessor. There is no basis for labelling Cargill Leasing's activities as likely to lead to tax abuse solely because of the nature of its ownership and, likewise, there is no credible reason for publicly owned companies to receive a more favorable tax treatment than privately owned companies.

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(1) U.S. Dept. of Treasury, "The Presidents 1978 Tax Program," Detailed Descriptions and Supporting Analyses of the Proposals, p. 112 undated.

Single Investor Leasing

The arguments against treating publicly and privately owned equipment lessors differently in the leveraged lease area apply in the same way to single investor leasing. The exact problems, however, are slightly different.

In the case of leveraged leasing, the principal area of concern is not permitting nonrecourse debt to be considered an amount "at risk". Since single investor leasing is not financed with nonrecourse borrowing, the source of funds used to buy the equipment does not affect the amount at risk.

However, if a privately owned company is subject to the at risk provisions while public companies are not, the private companies would also be at a competitive disadvantage in the single investor lease market. The reason for this is that Section 465(b)(4) does not permit a taxpayer to be considered at risk with respect to an amount protected against loss through "guarantees, stop loss agreements, or other similar arrangements."

It is common practice in the leasing industry for a lessor to obtain a performance guarantee from an equipment vendor or a member of the lessee group, such as a major shareholder of a "middle market" corporate lessee. The effect of the legislation would be to penalize the privately owned company for obtaining such a guarantee while the publicly owned company would not be penalized.[2] Cargill believes this inequity to be a gross misuse of the tax laws.

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(2) As an example of a publicly owned lessor obtaining equipment vendor guarantees, see p. 12 of Form 10-K filed by the Greyhound Corporation for its year ended December 31, 1977. This document discloses that Greyhound Leasing has obtained certain guarantees from railroad car manufacturers in connection with equipment leased to Conrail.

III

CONGRESS HAS RECOGNIZED THE NEED FOR AN
EXCEPTION FROM THE AT RISK RULES FOR CLOSELY HELD CORPORATIONS
ACTIVELY ENGAGED IN EQUIPMENT LEASING

Section 201 of the Revenue Act of 1978 provides an exception to the at risk rules for closely held corporations actively engaged in equipment leasing:

"(D) Exclusions-. . .

"(I) In the case of a corporation described in subsection (a)(1)(c) actively engaged in leasing equipment which is Section 1245 property, the activity of leasing such equipment shall be treated, for purposes of subsection (a), as a separate activity and subsection (a) shall not apply to losses from such activity.

"(II) A corporation described in subsection (a)(1)(C) shall not be considered to be actively engaged in leasing such equipment unless 50 percent or more of the gross receipts of the corporation for the taxable year are attributable, under regulations prescribed by the Secretary, to leasing and selling such equipment. . .

"(IV) In the case of a controlled group of corporations (within the meaning of Section 1563(a)) this paragraph shall be applied by treating the controlled group as a single corporation."

Although Cargill Leasing is in fact actively engaged in equipment leasing, this exception does not include Cargill Leasing. 100% of Cargill Leasing's gross receipts are attributable to the leasing and selling of equipment, yet when its receipts are compared to the total gross receipts of the Cargill controlled group, the percentage is substantially less than fifty percent.

The controlled group requirement for calculating the fifty percent gross receipts test not only will remove existing closely held leasing companies from the market, but will also prevent new leasing companies from entering the market. Assume for example, that a privately held corporation with revenues of $10 million decides to enter the equipment leasing business on the same terms as, and in direct competition with publicly held leasing companies. In order to do this, the privately held corporation creates a new wholly-owned subsidiary which establishes sales offices in several cities, hires salesmen and an administrative staff, and starts leasing equipment. Although these facts would indicate that the privately held leasing company should not be subject to the at risk rules (because it is "actively" engaged in equipment leasing), such private company would not come within the exception unless its revenues, when combined with the parent company revenues, exceed fifty percent of the total. Because of this requirement, the leasing company's gross receipts in its first year would have to be $10 million. This revenue requirement would be virtually impossible to accomplish and would result in privately held corporations being unable to enter the leasing business.

Although the exception from the at risk provisions for closely held corporations actively engaged in equipment leasing is not effective as it is presently drafted, the fact that such an exception exists indicates an intent on the part of the Conference Committee that publicly held and closely held equipment lessors should receive identical tax treatment. Cargill Leasing believes that there are meritorious arguments supporting this exception.

Proposals for extending the "at risk" rules of Section 465 to closely held corporations appear in the Administration's early 1978 tax legislative proposals. (3)

(3) U.S. Dept. of Treasury, "The President's 1978 Tax Program, Detailed Descriptions and Supporting Analyses of the Proposals", undated, pp. 64 ff and 109-116.

The Administration states that one of the weaknesses of the at risk rules is their inapplicability to corporations (except for personal holding companies and Subchapter S corporations). [4] It was felt that corporations should be covered because the Administration indicated that a high tax bracket shareholder-employee of a corporation could manipulate the taxable income of the corporation by proper timing of salary payments so that the benefits of a corporate tax shelter investment would accrue to the individual shareholder's benefit. [5] In addition, the Administration felt that the use of tax shelters could permit the avoidance of Section 531 Accumulated Earnings Tax and the Personal Holding Company Sections of the Code. [6]

The Administration's proposals draw a distinction between widely held corporations and closely held corporations as the Administration seems to believe that shareholder-employees of widely held corporations generally do not have the ability to control the timing and amount of their compensation in coordination with the investment policies of the corporation while shareholder-employees of privately held corporations would have this ability. Therefore, the Administration concludes that a pass through of tax shelter benefits to a shareholder-employee of a widely held corporation is unlikely; furthermore, the Administration concludes that the likelihood of the accumulated earnings tax being applied to a widely held corporation is small. [7]

(4) Id., p. 111.

(5) Id., p. 112.

(6) Id., n. 6.

(7) Staff of the Joint Comm. on Taxation, 95 Cong., 2nd, Sess., Tax Reduction and Reform Proposals, 2; Tax Shelters and The Minimum Tax 9 (Comm. Print April 14, 1978).

Cargill Leasing contends that there are two major fallacies with the Administration's distinguishing between corporations simply on the basis of ownership. One fallacy is that there is a presumption by the Administration that a closely held corporation is small enough to permit the integration of the shareholder-employees' personal tax planning with that of the corporation. This integration is not possible in large closely held companies. Furthermore, the concept of what constitutes a "closely held" corporation begins to cloud when the stock of a company is dispersed among the third, fourth and fifth generation of persons related to the original founders, and when the company is placed in the hands of professional management.

While it may be true that some closely held corporations attempt to avoid the accumulated earnings tax and personal holding company tax with this device, it is clear that closely held corporations also engage in nonrecourse financing of equipment leasing activities for other reasons, i.e., to obtain the same benefits of leverage that publicly held corporations receive in such transactions. The Carter Administration Tax Proposals give the stamp of approval to these transactions when engaged in by the publicly held corporations, but condemns them across the board when performed by privately held companies. [8] Cargill Leasing believes that when a privately held corporation is engaged in exactly the same activity as the publicly held corporation, there is no valid policy reason for treating the two differently.

A further reason given for treating widely held corporations differently from privately owned corporations is that widely held corporations, ". . .with the exception of equipment leasing, do not ordinarily enter into tax shelter investments and. . .these corporations are not affected by the accumulated earnings and personal holding company taxes and thus have no need of tax shelter deductions to avoid their

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(8) Supra n. 3, p. 112 "Thus, equipment leasing by a closely held corporation may lead to tax abuse, even though equipment leasing by a widely held corporation is generally a desirable activity."

application."[9] This reason does not address itself to theequipment leasing situation but rather ignores it. Cargill Leasing and other similarly situated closely held equipment lessors enter into the referred to "tax shelter" in exactly the same way. There is no reason for different tax treatment.

Cargill Leasing contends that any equipment lessor which is actively engaged in leasing equipment ought to be included in the exception without regard to its ownership or its impact on the consolidated gross receipts of the corporate group.

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(9) Staff of the Joint Comm. on Taxation, 95th Cong. 2nd Sess., Tax Reduction and Reform Proposals, 2; Tax Shelters and the Minimum Tax 9 (Comm. Print April 14, 1978).

AS A MATTER OF TAX POLICY, THE
AT RISK RULES OF SECTION 465 OUGHT NOT
TO BE EXTENDED TO CARGILL LEASING CORPORATION

As a matter of tax policy, the "at risk" rules of Section 465 ought not to be extended to Cargill Leasing Corporation. Cargill Leasing is an equipment lessor actively engaged in the leasing of equipment and as such plays an important role in today's economy which should be encouraged rather than deterred or eliminated. Cargill Leasing provides an alternate source of capital at lease rates substantially less than the equivalent interest rates which a financial institution would charge.

Approximately 75% of Cargill Leasing's portfolio is split equally among leases involving the agricultural, transportation and production/industrial sector of the economy and are with lessees individually having a net worth of between $200,000 and $2,000,000. This kind of lessee essentially represents the small to medium sized business and agricultural entrepreneur.

At a time when the cost of money is high, financial institutions may limit the amount of capital available to borrowers. Additionally, because of various states' usury laws, financial institutions may not be able to afford to lend money at the permitted rates. As the supply of capital available through financial institutions becomes tighter, alternate sources of capital become increasingly important to the small businessman. Even when there are funds available in financial institutions, the expending small businessman or farmer may be highly leveraged and unable to obtain bank financing or may be unable to take advantage of the tax incentives available to new investments. A corporate lessor, actively engaged in providing such an alternative source of capital to small and medium sized businesses and farms should not be taken out of this market through tax legislation which has as its primary purpose the elimination of tax abuse by tax shelter type arrangements.

Cargill Leasing is able to service the small to medium sized business market by making available a substantial part of its pool of capital at relatively low lease rates. In "The President's 1978 Tax Program, Detailed Descriptions and Supporting Analyses of the Proposals" issued by the Department of the Treasury, the Administration concludes at p. 112 that:

> ". . .equipment leasing by corporations has the desirable effect of making the tax incentives to new investment more efficient. . .The equipment lease allows the lessor to realize the benefit of the tax incentives, and to pass at least part of the benefit along in a form that the lessee can use - lower rents. . ."

By servicing small and medium sized businesses through leasing, Cargill Leasing's activities have the desirable effect in the economy stated by the administration. If privately held corporations are prohibited from using the tax benefits of equipment ownership as part of their lease rate calculation, the cost of leasing will increase.

Cargill Leasing does not believe that it is or should be Congress' intent to eliminate a viable competitor from either the single investor or leveraged lease market. This belief is based on the conclusion that tax policy should not decrease free competition in any market. In this case, tax legislation does have the effect of reducing competition. In the example discussed earlier in this paper, it was shown that a new leasing company created by a closely held corporate parent with gross receipts of $10 million would have to have gross receipts of $10 million in its first year of operations if it is to come within the presently drafted exception to the at risk rules. Because this amount of gross receipts is an impossible goal for a new lessor, the effect of this legislation is to discourage new entrants into the marketplace as well as to remove presently existing competitors. Economic

theory would indicate that raising artificial barriers to competition will ultimately lead to higher prices being imposed on the consumers of leasing services. Cargill Leasing particularly believes that tax legislation should not prevent a company like Cargill Leasing from providing service to the middle market not frequently courted by the larger lessors or prohibit it from engaging in active competitive bidding situations with its publicly held competitors.

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THERE IS A LEGISLATIVE ALTERNATIVE TO THE PRESENT STATUTORY SCHEME WHICH WOULD EXCLUDE CARGILL LEASING CORPORATION AND OTHER CLOSELY HELD COMPANIES ACTIVELY ENGAGED IN EQUIPMENT LEASING BUT WOULD CONTINUE TO SUBJECT POSSIBLE TAX ABUSE SITUATIONS TO THE AT RISK RULES

Section 465, as amended by the Revenue Act of 1978, contains an exception for companies actively engaged in equipment leasing. This exception is defective because it fails to include within the exception all actively operating leasing companies. The reason for this result is that the definition of a corporation actively engaged in leasing looks only at the gross receipts of the company from leasing and selling equipment. This approach addresses only one part of a two-part question, i.e., it is indicative of whether a corporation is engaged in the equipment leasing business but it is not indicative of whether such corporation is actively engaged in such business.

Cargill Leasing believes that Section 465 should be amended so that the test for determining whether a corporation is actively engaged in leasing equipment is a two-part test.

First, the gross receipts concept would be retained but applied only on a single company basis.

Second, a corporation which meets the first test would be required to meet some criteria which would distinguish between a company which is active and one which is not. This type of distinction is not without precedent in the Code; Section 542(c)(6)(B) exempts from the personal holding company provisions of the Code a lending or finance company if, among other things, it earns a certain portion of its income from ". . . the active and regular conduct of a lending or finance business. . ." Similarly, Section 542(c)(8) exempts from the personal holding company provisions, ". . . a small business investment company . . . which is actively engaged in the business of providing funds to small business concerns . . ."

Certain criteria which might be examined to determine whether or not a closely held leasing corporation is actively engaged in the leasing and selling of equipment which is Section 1245 property are the following:

(1) the employment of at least one full-time employee, the sole duty of whom is the solicitation of equipment leases;

(2) the ability of the corporation to borrow from unrelated sources on an uncollateralized basis;

(3) the completion of more than a few transactions in any given calendar year;

(4) the fact that the corporation is not used directly or indirectly for passive investment.

THE LEGISLATIVE HISTORY OF THE REVENUE ACT OF 1978 INDICATES THAT AN ACTIVE LEASING CORPORATION WAS NOT INTENDED TO BE SUBJECT TO THE AT RISK RULES

Legislative Chronology of the Revenue Act of 1978 as it Pertains to Subject Changes in the At-Risk Rules

In accordance with the legislative history of Title II of the Revenue Act of 1978, it is clear that the United States Congress adopted the general corporate attribution ownership rules of Section 318 and specifically rejected the personal holding company attribution ownership rules of Section 544; it is also clear that the House and Senate conferees recognized that this result was based on considerations of fairness and equity which suggested that United States taxpayers engaged in legitimate activities should not be subject to the at-risk rules just because they were privately held companies rather than publicly held companies.

An analysis of the specific legislative chronology on this matter reveals the following:

1. The Treasury Department's original proposal to subject closely held corporations to the at-risk rules across-the-board would cover legitimate leasing activities as well as tax abuse situations (for this purpose, Treasury determined an arbitrary distinction between the operations of publicly held companies and privately held companies, rather than providing for application of the at-risk rules on the basis of the nature of proscribed activities).
2. Although the House adopted portions of the Treasury proposals in this area, little, if any, attention was directed to the matter of the merits of applying the at-risk rules on the basis of ownership rather than the nature of the activities.

3. Furthermore, during the consideration of this legislation by the House, apparently no attention was directed to the issue of appropriate attribution rules if the Treasury ownership approach were utilized, and accordingly the Section 544 rules were adopted by the House, as recommended by the Treasury, without further consideration at that stage.
4. The Senate Finance Committee, and the full Senate, refused to embrace the changes in the at-risk rules recommended by the Treasury and deleted those provisions of the bill.
5. The House and Senate conferees, and ultimately the Congress as a whole, concluded that not all leasing activities of privately held corporations should be subject to the at-risk rule limitations based on the recognition that privately held companies, as well as publicly held companies, often engaged in legitimate leasing activities which should not be precluded.
6. The Congress was clearly aware of the various types of attribution rules for determining ownership of a closely held corporation. It is particularly significant that the Congress ultimately selected the Section 318 rules and specifically rejected the Section 544 rules.

Administration's Tax Proposals

In its detailed description and supporting analysis of the President's 1978 Tax Program, the Department of the Treasury related the following regarding the at-risk rules:(10)

> "Extension of At Risk Rules. The effectiveness of the at risk limitation added by the Tax Reform Act of 1976 (relating to the use of nonrecourse financing) will be enhanced by extending its application to certain closely held corporations and to all activities other than real estate."

* * *

(10) See The President's 1978 Tax Program, Detailed Descriptions and Supporting Analyses of the Proposals, pp. 69, 109-114.

Under present law, the at risk rules apply to investments in all activities except real estate. However, the at risk rules generally do not apply if a taxpayer invests in an activity directly (and not through a partnership). The at risk rules apply to direct investments only if they are made in movies, farming, leasing of property other than real estate, or oil and gas.

For the most part, the at risk rules do not apply to corporations. However, they do apply to personal holding companies and to Subchapter S corporations. In addition, they apply to a corporation which invests in an activity (other than movies, farming, leasing of property other than real estate, or oil and gas) through a partnership.

* * *

Reasons for Change

The at risk rules can be an effective means for dealing with certain tax shelter abuses that cannot be adequately dealt with on a case by case basis. They do not interfere with legitimate business transactions because they do not prevent a taxpayer from deducting losses that could possibly reduce his real wealth. There are, however, three weaknesses in the present at risk rules.

* * *

Second, the at risk rules generally do not apply to corporations. One leading member of the tax bar has commented on this as follows:

"It is difficult to find any logical reason for this favored treatment of corporations. It probably arises from the perception (clearly erroneous) that it is individuals who reap the maximum benefit from tax shelters, and from the view (equally erroneous)

that tax shelter syndicates do not generally include corporate limited partners. . . .If the Act is successful in closing the tax shelter syndication market to many individuals, the purveyors of tax shelters eventually will saturate the corporate market.

Tax shelter investments are as available to corporations as ever. To the extent individuals have been effectively legislated out of this market, the corporate investors should have less competition and therefore better terms. Of course, many corporations seeking tax shelter investments may be (and are) privately and very closely held. Indeed, tax shelter holds much attraction for those with Section 531 problems; accumulated earnings are available to buy shelter. Publicly owned corporations, with the exception of financial institutions and insurance companies which represent the principal market for equipment leasing tax shelters, generally have not indulged in pure tax shelter transactions."

* * *

General Explanation

Under the proposal, the at risk rules will extend to all activities except real estate. They will apply whether an investment is made directly or through a partnership. In addition, the at risk rules will extend to all closely held corporations (i.e., to all corporations that have five or fewer controlling shareholders). Further, a special provision will be added to prevent taxpayers from using careful timing to circumvent the at risk rules.

* * *

Although widely held corporations have made limited use of other tax shelters thus far, they may enter the market after other taxpayers have been excluded by these proposals. The Administration will continue to monitor tax shelter activity and will propose further expansion of the rules in this area if new abuses develop.

* * *

Under present law, the at risk rules do apply to personal holding companies. Personal holding companies are more likely than most other corporations to invest in tax shelters because they are closely held. Five or fewer shareholders must own more than 50 percent of the stock of a personal holding company. A closely held corporation may be able to pass the benefits of a tax shelter through to its shareholders, if the shareholders are also employees. [5] Thus, an investment made by a closely held corporation in a tax shelter may be equivalent to an investment made directly by the shareholders. Even if the controlling shareholders are not all employees, tax shelters may be used to defeat the accumulated earnings tax. [6]

On the other hand, these opportunities are generally not available to widely held corporations. Few employees of a widely held corporation are able to control the timing and amount of their compensation, and no shareholder is likely to be able to control the corporation's investment policy. In addition, few widely held corporations are subject to the accumulated earnings tax. Further, a widely held corporation is unlikely to enter into a transaction that has no economic substance because such a transaction may be challenged either by shareholders or the Internal Revenue Service.

A widely held corporation generally is subject to frequent audits by the Internal Revenue Service and to the public disclosure requirements of the Securities and Exchange Commission.

It has been common for widely held corporations to invest in only one kind of tax shelter -- equipment leasing. However, equipment leasing by corporations has the desirable effect of making the tax incentives to new investment more efficient. Typically, the lessee does not have enough income to make full use of these tax incentives (chiefly the investment credit and accelerated depreciation). On the other hand, the lessor (typically a bank) does have enough income. The equipment lease allows the lessor to realize the benefit of the tax incentives and to pass at least part of the benefit along in a form that the lessee can use -- lower rents. Because the same corporate tax rate applies to both the lessee and the lessor, the tax benefit is no greater than Congress intended it to be. However, if the lessor is a closely held corporation, there can be an abuse. As previously explained, an investment made by a closely held corporation in a tax shelter may be equivalent to an investment made directly by the shareholders. Where this is so, and where the shareholders are in tax brackets above the maximum corporate rate, the tax benefits will exceed those which Congress intended to provide. Thus, equipment leasing by a closely held corporation may lead to tax abuse, even though equipment leasing by a widely held corporation is generally a desirable activity. (Emphasis Supplied.)

The Internal Revenue Code now contains two different sets of at risk rules. The first set (Section 465 of the Code) applies to four activities--movies, farming, leasing of property other than real estate, and oil and gas. It applies whether an investment in one of these four activities is made directly or through a partnership. The second set of at risk rules (Section 704 (d) of the Code) applies to all other activities, except real estate. However, it applies only to investments that are made through a partnership (and not to those that are made directly). The Administration proposal will extend the first set of rules (Section 465) to all activities except real estate. Therefore, the second set of rules (Section 704(d)) will become unnecessary and will be repealed.

The at risk rules will also be extended to apply to all closely held corporations (i.e., all corporations in which five or fewer shareholders own more than 50 percent of the stock). Thus, the at risk rules will apply to any corporation that meets the stock ownership test for a personal holding company, regardless of the source of the corporation's income. On the other hand, the at risk rules will be restricted to Subchapter S and closely held corporations, and will not apply to other corporations in any circumstances.

House Ways and Means Committee Proceedings

Following hearings on the President's Tax Program, on April 12, 1978, at the request of the Administration, Chairman Ullman of the House Ways and Means Committee introduced H.R. 12078, under which Section 243 provided for extension of at-risk provisions to closely held corporations and to all activities except real estate.

It is important to recognize that early in the process of the legislative history of the Revenue Act of 1978, various members of the House

Ways and Means Committee expressed concern and reservations about the entire tax reform package presented to the Congress by the Administration and the Treasury Department.

The President's tax reform package attracted substantial opposition within the House Ways and Means Committee from the outset, and the mark-up process was suspended for a substantial period of time while members of the Committee attempted to agree on some form of compromise so that it would be possible to proceed with consideration of the legislation. The absence of a consensus and strong opposition to the President's proposals resulted in major difficulties at this stage of the legislative process.

After substantial deliberations, subsequently new initiations by key members of the House Ways and Means Committee, a compromise bill was sponsored by Chairman Al Ullman, Ranking Minority Member Barber Conable, and Member James Jones.

In a committee print prepared for the House Ways and Means Committee concerning tax shelters and minimum tax, dated April 14, 1978, the staff of the Joint Committee on Taxation noted the following concerning the Administration's proposals on the at-risk rules:(11)

* * *

"Administration Proposal

* * *

Issues

"The Administration's proposal would amend the specific at risk rule in three ways. The at risk rule would be 1) extended to apply to direct

(11) See Tax Reduction and Reform Proposals No. 2, Tax Shelters and Minimum Tax, pp. 3, 7-10, April 14, 1978.

"investments in all types of activities (except real estate), rather than just the four types of activities now covered; 2) extended to apply to certain closely held corporation; and 3) provide for the recapture of previously allowed deductions where there were withdrawals of amounts originally placed at risk.

* * *

Extending at risk rule to closely held corporations.

The Administration proposal would make the at risk rule applicable to closely held corporations (i.e., those in which five or fewer individuals own more than 50 percent of the stock). This raises the broad issue of whether it is appropriate to exempt corporations from the at risk rules.

The Administration asserts that this proposal would curtail the use of tax shelter deductions by closely-held corporations to avoid the accumulated earnings tax and the personal holding company tax and to shelter income on which owner-employees would otherwise pay tax at the individual level.

Others argue that closely held corporations should not be subject to the at risk rule and point out that the specific at risk rule already applies to personal holding companies and Sub-chapter S corporations. These types of corporations may represent a higher risk from a tax avoidance standpoint than other closely hold corporations.

Some contend that the corporate exemption under the present at risk rules is not justified for any corporations because corporations, being subject to a flat 48 percent normal and surtax tax rate, can and do obtain substantial tax benefits from tax shelter investments. Moreover, it is argued that the corporate exemption will create a concentration of tax

"shelter investments in the corporate sector. While the Administration proposal would remove the corporate exemption for closely held corporations, those that make this argument state that the proposal does not go far enough.

Essentially, the Administration's reasons for continuing the corporate exemption from the at risk rules for widely held corporations are that these corporations, with the exception of equipment leasing, do not ordinarily enter into tax shelter investments and that these corporations are not affected by the accumulated earnings and personal holding company taxes and thus have no need of tax shelter deductions to avoid their application. Moreover, these corporations are subject to public reporting requirements and other scrutiny which make it unlikely that they would engage in a venture which was questionable under the tax law or which did not make sense from an economic standpoint.

While it recognizes that widely held corporations (particularly, banks and insurance companies) are involved in equipment leasing tax shelter investments, the Administration asserts that these investments have the desirable effect of making the tax incentives for new investment more efficient. Further, it states that, because the same corporate tax rate applies to both the lessee (which is a corporation in almost all cases) and the lessor, the tax benefit is no greater than Congress intended it to be. The Administration asserts that this is distinguishable from the closely held corporation situation, where the tax shelter benefits can, in effect, be passed through the shareholder-employees who are in a higher marginal tax bracket than the flat corporate normal and surtax tax rate.

It is also argued that the proposed widely held corporate exemption could create (or exacerbate) a competitive disadvantage

between smaller corporate taxpayers subject to the at risk rule and larger corporate taxpayers not subject to the rule. Moreover, certain administrative problems, discussed below, may be exacerbated if the at risk rule is extended to small corporations." (Emphasis Supplied)

As noted above, on July 13, 1978, Chairman of the House Ways and Means Committee Al Ullman, Member Jones, and Ranking Minority Member Barber Conable introduced H.R. 13511 which was referred to the House Ways and Means Committee. Section 202 of this bill provided for extension of the at-risk provisions to closely held corporations.

In its report on H.R. 13511, the Revenue Act of 1978, dated August 4, 1978, the House Ways and Means Committee provided the following explanation about the changes adopted concerning the at-risk rules: (12)

" Reasons for change

The at risk rules of present law impose a significant limitation on many types of tax shelters. However, the rules do not cover three types of situations where the use of tax shelters should be further restricted. First, except in case of the four types of activities specified in section 465, the at risk rules do not apply to direct investments. Second, the at risk rules do not apply to many types of closely held corporations which may use tax shelters. Third, the current at risk provisions fail to adequately deal with situations where a taxpayer receives distributions (or otherwise reduces his original at risk basis through debt guarantees, conversion of debt from recourse to nonrecourse, etc.) after having used his at risk basis to support losses in a prior year.

* * *

(12) See Report on the Revenue Act of 1978 together with Additional, Supplemental, Separate and Dissenting views, 95th Cong. 2d Sess. pp. 69-78, August 4, 1978.

Under present law, the at risk rule is applicable only to subchapter S corporations and personal holding companies and not to other closely held corporations. Other closely held corporations can continue to use tax shelter deductions to avoid the accumulated earnings tax or to shelter income on which owner-employees would otherwise pay tax at the individual level. To eliminate this type of income sheltering by corporations, the committee believes that the at risk rules should be extended to closely held corporations.

* * *

Extension of at risk rules to closely-held corporations

Under present law, the only corporations to which the specific at risk rule (sec. 465) applies are subchapter S corporations and personal holding companies. The bill extends the application of this rule to all corporations in which five or fewer individuals own more than 50 percent of the stock.

The stock ownership rule is determined by reference to the stock ownership rule for personal holding companies under section 542(a)(2). Thus, a corporation will be subject to the at risk rule if, at any time during the last half of the taxable year, more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. In applying this stock ownership rule, a pension trust, a supplemental employemnt benefit trust (sec. 501(c)(17), a charitable organization (described in sec. 509(a)), or a portion of a trust permanently set aside or to be used exclusively for charitable purposes (described in sec. 642(c)) shall be considered an individual.

If a corporation meets these ownership requirements, it will be subject to the at risk rules even if it does not meet other definitional requirements of a personal holding company (see sec. 542(a)(1)) or because it is excepted from personal holding company status (by sec. 542(c)). (Emphasis Supplied)

On August 10, 1978, by a vote of 263 yeas to 49 nays, the United States House of Representatives passed H.R. 13511, as amended, adopting the changes in the at-risk rules recommended by the House Ways and Means Committee.

Senate Proceedings

On August 14, 1978, H.R. 13511 was introduced in the United States Senate and referred to the Senate Finance Committee.

On October 1, 1978, the Senate Finance Committee reported H.R. 13511, as amended, to the full Senate.[13] The Senate Finance Committee amended H.R. 13511 to delete the provisions for extension of the at-risk rules adopted by the House Ways and Means Committee and the full House.

On October 10, 1978, by vote of 86 yeas to 4 nays, the United States Senate passed H.R. 13511, as amended, and instructed its conferees to insist on the Senate amendments when meeting with the House conferees.

Conference Proceedings

On the matter of changes in the at-risk rules, the Conference Report on H.R. 13511, as adopted by the House and Senate conferences on October 14, 1978, provided:[14]

"(ii) Equipment Leasing By Closely-Held Corporations--

"(I) In the case of a corporation described in subsection (a)(1)(C) actively engaged in leasing equipment which

(13) See H.R. 13511, (Report No. 95-1263), 95th Cong., 2d Sess., October 1, 1978.

(14) See Conference Report (H. Rept. 95-1800), Cong. Rec. No. 168 - Part III, 95th Cong., 2nd Sess., p. H 13211-13212, October 14, 1978.

is section 1245 property, the activity of leasing such equipment shall be treated, for purposes of subsection (a) as a separate activity and subsection (a) shall not apply to losses from such activity.

"(II) A corporation described in subsection (a)(1)(C) shall not be considered to be actively engaged in leasing such equipment unless 50 percent or more of the gross receipts of the corporation for the taxable year are attributable, under regulations prescribed by the Secretary, to leasing and selling such equipment.

"(III) For purposes of this paragraph, the leasing of master sound recordings, and other similar contractual arrangements with respect to tangible or intangible assets associated with literary, artistic, or musical properties shall not be treated as leasing equipment which is section 1245 property.

"(IV) In the case of a controlled group of corporations (within the meaning of section 1563(a)), this paragraph shall be applied by treating the controlled group as a single corporation." (Emphasis Supplied)

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"Sec. 202. Extension of At Risk Provisions to Closely Held Corporations. Subsection (a) of section 465 (relating to deductions limited to amount at risk) is amended to read as follows:

"(a) Limitation to Amount at Risk-

"(1) In General-In the case of-

"(A) an individual,

"(B) an electing small business corporation (as defined in section 1371(b)), and

"(C) a corporation with respect to which the stock ownership requirement of paragraph (2) of section 542(a) (determined by reference to the rules contained in section 318 rather than under section 544) is met, engaged in an activity to which this section applies, any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of subsection (b)) (for such activity at the close of the taxable year." (Emphasis Supplied)

* * *

Sec. 204. Effective Dates.

(a) In General-The amendments made by this subtitle shall apply to taxable years beginning after December 31, 1978.

* * *

(JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF THE CONFERENCE)

* * *

II. Tax Shelter and Partnership Provisions

31. Modifications of at Risk Provisions

Conference agreement.-The conference agreement follows the House bill, with certain modifications.

First, at the risk rule is not to apply to closely held corporations (i.e., where five or fewer individuals own 50 percent or more of the stock of the corporation) to the extent they are actively engaged in leasing equipment which is section 1245 property. A closely held corporation will not be considered to be actively engaged in equipment leasing unless 50 percent or more of its gross receipts for the taxable year are attributable to equipment leasing. For purposes of this test, gross receipts are to include gross receipts from the sale or the servicing of the same type of equipment leased by the corporation. "Equipment leasing" includes the leasing of such tangible personal property as computers, copiers, calculators, airplanes, automobiles, tractors, cranes, railroad cars, and furniture. "Equipment leasing" does not include the leasing of master recordings and other similar contractual arrangements made with respect to tangible or intangible assets associated with literary, artistic, or musical properties (such as books, lithographs of works of art, or musical tapes). Equipment leasing would also not include any lease activity which is described in section 465(C)(1) (A),(B),or (D) (relating to motion picture films or video tapes, farming, and oil and gas property). Thus, for example, the lease of a video tape (which is described in section 465(C)(1)(A)) would not be considered equipment leasing. (Emphasis Supplied)

* * *

"Second in determining whether 5 or fewer individuals own 50 percent or more of the stock of a corporation (thus, making the corporation subject to the at risk rule), the attribution rules of section 318 not section 544 are to apply." (Emphasis Supplied)

Following enactment of the Revenue Act of 1978, P.L. 95-600, the staff of the Joint Committee on Taxation noted the following in its Section-by-Section Summary:[15]

"Sec. 202. Extension of at Risk Provisions to Closely Held Corporations.

Under prior law, the only corporations to which the specific at risk rule applied were subchapter S corporations and personal holding companies. The Act extends the application of this rule to all corporations in which five or fewer individuals own more than 50 percent of the corporation's stock. However, the equipment leasing activities of a closely held corporation are not to be subject to the at risk rule if the corporation is actively engaged in equipment leasing, that is, if 50 percent or more of the corporation's gross receipts is derived from equipment leasing. This provision is effective for taxable years beginning after December 31, 1978."

(15) See Section-by-Section Summary of the Revenue Act of 1978, Energy Act of 1978, Foreign Earned Income Act of 1978 and Fringe Benefits Plan p. 26, November 27, 1978.

Technical Corrections Act of 1979

With respect to changes in the at-risk attribution rules adopted under the Revenue Act of 1978, H.R. 2797, the Technical Corrections Act of 1979 provides:(16)

"SEC. 102. AMENDMENTS RELATED TO TITLE II.

22 (a) GENERAL RULE.-

23 (1) AMENDMENTS RELATED TO SUBTITLE A OF

24 TITLE II OF THE ACT.-

1 (A) STOCK OWNERSHIP RULES.-Subsection

2 (a) of section 465 (relating to deductions limited

3 to amount at risk) is amended-

4 (i) by striking out "(determined by re-

5 ference to the rules contained in section 318

6 rather than under section 544)" in paragraph

7 (1)(C), and

8 (ii) by adding at the end thereof the fol-

9 lowing new paragraph:

10 "(3) SPECIAL RULES FOR APPLYING PARAGRAPH

11 (C)-For purposes of paragraph (1)(C)-

12 "(A) section 544(a)(2) shall be applied as if

13 such section did not contain the phrase 'or by or

14 for his partner'; and

15 "(B) sections 544(a)(4)(A) and 544(b)(1) shall

16 be applied by substituting 'the corporation meet

17 the stock ownership requirements of section

18 542(a)(2)' for 'the corporation a personal holding

19 company'.""

(16) See H.R. 2797, 96th Cong., 125 Sess., pp. 20-21, March 12, 1979.

In its description of H.R. 2797 and S. 614, the Technical Corrections Act of 1979, dated March 14, 1979, the staff of the Joint Committee on Taxation related the following concerning the provision directed to correction of at risk attribution rules: (17)

"Correction of attribution rules for at risk limitations (sec. 102(a)(1)(A) of the bill and sec. 465(a) of the Code).

Prior to the Revenue Act of 1978, the only types of corporations to which the at risk rules (Code sec. 465) applied were subchapter S corporations and personal holding companies. Consequently, there was no need under prior law for attribution rules with respect to whether a corporation was a subchapter S corporation or not, and the reference to personal holding companies resulted in the application of the personal holding company attribution rules.

The Act extended the application of the at risk rules to certain closely held corporations (even though they would not qualify as personal holding companies and had not made subchapter S elections). The closely held corporations to which these rules were extended included any corporation in which five or fewer individuals owned 50 percent or more of the stock. However, in determining whether this ownership test was met, the attribution rules under section 318 of the Code, rather than under section 544 of the Code, were to be applied.

In general, the attribution rules of section 318 are much narrower than those of section 544, which, inter alia, provide for attribution of one partner's stock to another partner in the same partnership and for broader family and corporate attribution. Under section 544,

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(17) See Description of H.R. 2797 and S. 614: Technical Corrections Act of 1979, pp. 12-13, March 14, 1979.

stock in one corporation (the "subsidiary") owned by another corporation (the "parent") is attributed to the parent's shareholders in proportion to the shareholders' ownership in the parent. However, under section 318, the stock of a subsidiary corporation is considered as owned by a shareholder of the parent corporation only if the shareholder owns 50 percent or more in value of the stock of the parent corporation. Similarly, under section 544, an individual is considered as owning stock owned directly or indirectly by his brothers and sisters, spouse, ancestors, and lineal decendants; however, under section 318, an individual is treated as owning only the stock owned directly or indirectly by his spouse, children, grandchildren, and parents.

The Act adopted the attribution rules of section 318 primarily because it was thought inappropriate to attribute one partner's stock in a corporation to another partner in the same partnership. However, in adopting the attribution rules of section 318, the Act inadvertently permitted exemption from the at risk rules where the stock ownership of the corporation warranted application of the risk rules (e.g., where the corporation was a personal holding company but did not meet the section 318 attribution rules).

The bill would provide generally that, in determining whether five or fewer individuals own 50 percent or more of stock of a corporation under the at risk rules, the rules of section 544 which relate to attribution of stock ownership are to be applied. However, those rules of section 544 relating to attribution of stock ownership from one partner to another would not be applied."

Notwithstanding the statement, noted above, in the recent Committee Print prepared by the staff of the Joint Committee on Taxation recommending the

change in the stock ownership rules for closely held corporations provided under Section 102 (a)(1)(A) of the Technical Corrections Act of 1979, such a change from the Section 318 attribution rules to the Section 544 attribution rules for privately held (closely held) corporations would be contrary of the intent of the Congress, under the provisions of the Revenue Act of 1978, for it is clear that the House and Senate conferees wished to preserve the competitive position of privately held corporations which engage in legitimate leasing activities. This change in attribution rules, without other adjustments, would result in the elimination from this market of privately held corporations which engage in legitimate leasing activities, including equipment leasing.

It is clear that the House and Senate conferees for the Revenue Act of 1978 intended to provide for fair and equitable operation of the at-risk rules to insure that legitimate leasing activities, and particularly equipment leasing activities, would not be eliminated through extension of the at-risk limitations. More specifically, the Congress recognized inherent economic distinctions between legitimate leasing activities, such as equipment leasing, on the one hand and tax abuse situations on the other. In this regard, it is the nature of the leasing activities rather than ownership which should be determinative for tax purposes.

As noted above, the Congress recognized that the effect of subjecting privately held leasing firms to the at-risk limitations, while not subjecting similarly situated publicly held firms to the same limitations, would be to shift important commercial advantages to publicly held firms with the result that privately held firms would be excluded from this market.

Based on the points, authorities, developments and considerations set forth above, it is clear, pursuant to the legislative history of the Revenue Act of 1978, that the House and Senate conferees, and the Congress as a whole, did not intend to subject legitimate leasing activities of privately held companies, with particular reference to equipment leasing, to the at-risk limitations.

CONCLUSION

It is Cargill Leasing's position that as a closely held corporation actively engaged in the regular conduct of the business of leasing and selling equipment which is Section 1245 property, the at risk rules of Section 465 of the 1954 IRC should not apply to any of its operations nor to the operations of any similarly situated leasing corporation.

GENERAL ELECTRIC CO.,
Fairfield, Conn., November 16, 1979.

Hon. HARRY F. BYRD, Jr.,
Committee on Finance,
Dirksen Office Building, Washington, D.C.

DEAR SENATOR BYRD: I am writing to request that the Committee on Finance include in the Technical Corrections Act of 1979 (H.R. 2797) a much needed amendment to the Internal Revenue Code relating to deductions for contribution to foreign pension plans.

Plans maintained outside of the United States primarily for the benefit of nonresident alien employees are exempt from all of the requirements of Title I of ERISA. The Conference Report on ERISA suggests that exemption of such plans from the qualification requirements added to the Internal Revenue Code by Title II of ERISA was unnecessary, because the plans "would have no need to seek tax deferral qualification." H.R. Rep. 93-1280, p. 291, 1974-3 CB 452. However, this is not the case. The Internal Revenue Service has ruled in LTR-7904042 that contributions by a U.S. employer to a foreign trust maintained under such a plan are not deductible under Code section 404(a)(4) unless the plan meets all of the requirements of the Code for qualified plans, including those added by Title II of ERISA. The ruling also held that since the plan is a defined benefit plan and not an individual account plan (funds in the trust are unallocated), no deduction is allowable under Code section 404(a)(5)—the section applicable to nonqualified plans—even when amounts are distributed to the participants. The result is that the employer is *never* allowed a deduction for his contributions to the plan.

These constraints on the allowability of business expense deductions for contributions to foreign plans primarily benefiting nonresident aliens are clearly unreasonable and we do not believe that Congress intended to impose them.

We respectfully request that this technical legislative oversight be corrected by amending Code section 404(a)(4) retroactively to allow a deduction for contributions by a U.S. employer to a foreign situs stock bonus, pension or profit sharing trust which is part of a plan maintained outside of the United States primarily for nonresident aliens and under which the contributions cannot revert to the employer prior to satisfaction of all liabilities under the plan. A draft of a legislative amendment to make this technical correction is attached.

The consideration of this matter by the Subcommittee on Taxation and Debt Management Generally will be much appreciated.

Very truly yours,

P. S. WELCH
Manager, Tax Accounting Operation.

Attachment.

SEC. –. TRUSTS CREATED OR ORGANIZED OUTSIDE THE UNITED STATES

(a) *General rule.*—Section 404(a)(4) of the Internal Revenue Code of 1954 (relating to deductions for contributions of an employer to trusts created or organized outside the United States) is amended to read as follows:

"(4) *Trusts created or organized outside the United States.*—
Contributions to a stock bonus, pension, or profit-sharing trust by an employer which is a resident, or corporation, or other entity of the United States shall be deductible under the preceding paragraphs if—

(i) the trust would qualify for exemption under section 501(a) except for the fact that it is a trust created or organized outside the United States; or

(ii) such trust is part of a plan maintained outside the United States primarily for the benefit of persons substantially all of whom are nonresident aliens, and, under the law of a foreign country or under the governing instrument of the plan, it is impossible, at any time prior to the satisfaction of the claims of the participants and beneficiaries of the plan, for any part of the contributions made in any taxable year or any income therefrom to revert (within the taxable year or any subsequent taxable year) to the employer or any person which is a member of a controlled group with (within the meaning of section 414(b)) or under common control with (within the meaning of section 414(c)) the employer.

(b) *Effective date.*—The amendment made by this section shall apply to taxable years ending after August 31, 1974.

GROOM & NORDBERG,
Washington, D.C., November 28, 1979.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: This statement is submitted for inclusion in the record of the November 7, 1979 hearing of the Subcommittee on the "technical Corrections Act of 1979." It is filed on behalf of The Prudential Insurance Company of America ("Prudential"). Prudential is a major U.S. mutual life insurance company; a substantial part of its business is the funding and administration of tax-favored retirement plans.

In response to the enactment in the Revenue Act of 1978 of the Simplified Employee Pension ("SEP") plan (section 408(k) of the Code), Prudential has developed a SEP program for adoption by employers. Our statement relates to one of the additional technical corrections proposed by the Treasury Department at the November 7 hearing which relates to SEPs. Specifically, our statement concerns the Treasury proposal to clarify the law so that, for purposes of the limitations on contributions and benefits imposed on tax-favored retirement plans (sec. 415), employer contributions to SEPs are aggregated with employer contributions to other qualified defined contribution plans (sec. 401). Prudential generally agrees that such a change is appropriate. The purpose of this letter is to recommend that, if such an amendment is adopted, such amendment should not also require aggregation of employer contributions to a SEP provided by an employer which a participant does not "control" with contributions to other plans provided by an employer which the participant does "control."

Under present law, the limitations on contributions and benefits under tax-favored retirement plans are generally applied by aggregating plans "of the same employer." See IRC §§ 415(e), (f), (g). The purpose of this rule is to prevent an employer from avoiding the applicable limitations through the establishment of multiple plans H.R. Rep. No. 93-807, 93d Cong., 2d Sess. 122 (1974). Technically, the Code now departs from this "same employer" principle with respect to SEPs because a SEP provided by an employer will be aggregated with a defined contribution plan of that employer only where the participant is in "control" (*i.e.*, where the participant has a more than 50 percent ownership interest) of such employer. The Treasury proposal to resolve this problem apparently would provide for the treatment of employer contributions to SEPs in the same manner as employer contributions to any other defined contribution plan (under section 415(c) of the Code).

We note that it is quite possible for a person who participates (as an employee) in a SEP provided by an "uncontrolled" employer to also maintain for himself or herself a Keogh or H.R. 10 plan with respect to which such person makes deductible contributions based on his or her income from self-employment. Under present law, if the "uncontrolled" employer made contributions for this person to, e.g., a qualified profit-sharing plan, instead of a SEP, the employer's profit-sharing contributions would not be aggregated with the person's H.R. 10 plan contributions. We believe it is important that any amendment on this subject not apply a more restrictive aggregation rule to participants in SEPs. More specifically, employer contributions to a SEP provided by an "uncontrolled" employer should not be aggregated with contributions to an H.R. 10 plan maintained by an employer which the SEP participant does "control."

In summary, we recommend that the resolution of the technical problem identified by the Treasury Department not unnecessarily limit employer contributions to "controlled" H.R. 10 plans and "uncontrolled" SEPs. It would appear that one way to accomplish that result would be to delete the current reference to simplified employee pensions in section 415(e)(5) of the Code.

We appreciate the opportunity to make this comment. If you or staff has any questions on this subject, please contact the undersigned.

Very truly yours,

LOUIS T. MAZAWEY,
Attorney,
Prudential Insurance Co. of America.

STATEMENT OF THE NATIONAL REALTY COMMITTEE ON H.R. 2797, THE "TECHNICAL CORRECTIONS ACT OF 1979"

The National Realty Committee, Inc., a non-profit business league whose membership includes owners, operators and developers of all types of real estate throughout

the United States, offers the following statement, concerning certain aspects of the Technical Corrections Act of 1979, for consideration and action by the Senate Finance Subcommittee on Taxation and Debt Management.

The National Realty Committee wishes to address only two issues, each of which concerns the extension of the investment credit to expenditures for "qualified rehabilitated buildings" enacted as part of the Revenue Act of 1978.

Prior to extension of the investment credit to qualified rehabilitations, the investment credit provisions were generally inapplicable to commercial real estate. Accordingly, the investment credit statutory scheme, including peripheral limitations on the availability of the credit, was enacted with a view of depreciable personality. The extension of the credit to qualified rehabilitations makes an examination of the applicability of those peripheral provisions to commercial real estate an important undertaking for the first time.

EXEMPTION FROM LIMITATIONS ON NONCORPORATE LESSORS

In this connection, the National Realty Committee vigorously supports Section 103(a)(3)(A) of the Technical Corrections Act, as passed by the House of Representatives on July 16, 1979. This section exempts otherwise creditable rehabilitations from the limitations of Code Section 46(e)(3).

Code Section 46(e)(3) in its present form denies an investment credit to noncororate lessors who, in general, either net lease their property, or lease their property for at least half its useful life. There is an exception to 46(e)(3) that would allow the credit if 'the property subject to the lease has been manufactured or produced by the lessor. . . ." The term "manufactured or produced by the lessor" would seemingly include all taxpayers who incur qualified rehabilitation expenditures. The regulations explain, however, that the exception is only intended to apply to a lessor who manufactures or produces the property in the ordinary course of his business, effectively limiting this exception to those taxpayers who are in the business of rehabilitating buildings.

Because commercial real estate is frequently held in non-corporate form, and since long-term leases and net leases are customary in large segments of real estate industry, the Section 46(e)(3) limitation would make the investment credit unavailable for a substantial number of otherwise creditable rehabilitations. The National Realty Committee believes that the applicability of this limitation to non-corporate lessors of real estate substantially frustrates the congressional purpose in extending the investment credit to the rehabilitation of qualified buildings.

Moreover, the orignial congressional purpose in enacting the limitation of Code Section 46(e)(3) would be substantially exceeded by applying it to otherwise creditable rehabilitations. The purpose of the limitation in Section 46(e)(3) was to prevent the use of the investment tax credit for tax-shelter transactions in which corporate users of equipment, by means of sale-lease back or similar methods, would lease equipment from high-bracket individuals. Such transactions would transfer the benefit of the credit to those high-bracket individuals without the need for the corporation to relinquish use and control of the equipment that is the subject of the credit.

Business and industrial equipment is constomarily purchased by the intended user. A decision by a corporate user to lease equipment rather than to purchase is generally a financing decision. Transfer of the investment tax credit and other tax benefits arising from the ownership of the property to an individual lessor, in effect, would permit the corporate user to finance the equipment at a lower net cost than would be incurred by direct acquisition.

This is in contrast to the case of commercial rental real estate, in which the owner of the property is customarily not the user. The actual use of the real estate by tenant-lessees, rather than by the owner, is inherent in the nature of the asset involved. It is not merely a financing decision to traffic in the benefits of the investment credit. Unlike the case of an individual who leases equipment to corporate users on a long-term basis, the practical ownership, control and risk of a rehabilitated building generally reside in the individual incurring the rehabilitation expense. Therefore, the congressional purpose underlying Code Section 46(e)(3) has very limited, if any, applicability to creditable rehabilitations of commercial real property.

Another distinction between typical real property situations and the equipment leasing transactions, to which Code Section 46(e)(3) was intended to apply, is the multiplicity of leases usually present in the case of real property. Unlike the equipment leasing transaction, in which the creditable property, i.e., the equipment, is leased to a single lessee, rehabilitated commercial real property will often be leased to a number of tenants under a variety of leases.

The existence of multiple leases with varying terms in a commercial rental building makes application of the statutory test of Code Section 46(e)(3) extremely cumbersome, in comparison to the leasing of a single item of depreciable personalty. Accordingly, if Section 46(e)(3) is to be applicable to real property transactions, complicated and arbitrary allocation rules will inevitably be needed to determine which rehabilitation components are leased for at least half their useful lives. The allocation process will be difficult because the useful lives of the different components, the portion of the building benefited by those components, as well as the periods of the different leases, can vary substantially within a single building.

PROPERTY USED BY TAX EXEMPT AND GOVERNMENT ENTITIES

Consistent with the purpose of and justification for the exemption from Code Section 46(e)(3) already contained in the technical Corrections Act, the National Realty Committee requests that this Committee similarly exempt otherwise qualifying creditable rehabilitation expenditures from the limitations of Code Sections 48 (a)(4) and (5).

Sections 48 (a)(4) and (5) deny the availability of the investment credit to property used by organizations exempt from income tax (except if predominantly used in a taxable business), or used by the United States, any state or local government, and any international organization. Thus, under present law, the credit is not available if any such organization or entity is either the owner or lessee of otherwise eligible property.

The application of this limitation to commercial rental property could effectively eliminate governent and non-taxable entities as potential tenants in buildings where the owner has either made or plans to make rehabilitation expenditures. For some buildings particularly downtown office buildings in areas where tax-exempt and government entities comprise a significant part of the potential market for leased space, the limitation could eliminate any incentive for rehabilitation provided by the investment credit. This would clearly frustrate the congressional objective of providing special encouragement for the rehabilitation of older buildings.

In addition to diminishing the incentive for rehabilitating commercial rental property, the application of Sections 48(a) (4) and (5) to commercial real estate could create several complications. An owner who has made qualifying rehabilitation expenditures and obtained an investment credit may find that a tenant has subsequently subleased a portion of the space to a proscribed subtenant, causing the owner to be treated as having made a disposition of the rehabilitated property to the extent of the subleased space. This could result in recapture of a portion of the owner's investment credit, even though the owner was not a party to the sublease. Finally, leasing a portion of a building to a proscribed tenant could cause substantial allocation problems in ascertaining the portion of the total qualified rehabilitation expenditure attributable to the space leased to the proscribed tenant.

In short, the National Realty Committee believes that excepting otherwise creditable rehabilitation expenditures from the limitations of Code Section 46(e)(3) and Code Sections 48(a) (4) and (5) is consistent with and necessary to effectuate fully the purpose of Congress in extending the investment credit to rehabilitations of eligible buildings.

McDermott, Will & Emery
Chicago, Ill., November 20, 1979.

Mr. Michael Stern,
Staff Director, Senate Finance Committee,
Dirksen Senate Office Building, Washington, D.C.

Dear Mr. Stern: The following will register comments on behalf of clients of our firm regarding portions of H.R. 2797 (Technical Corrections Act of 1979) relating to the modification of Section 105(h) of the Internal Reveue Code of 1954, as amended.

Prior to the passage of the Revenue Act of 1978, which under Section 366 of that Act added Section 105(h) to the Code effective for taxable years beginning after December 31, 1979, many employers had established non-insured medical expense reimbursement plans to pay or reimburse all or a portion of the costs incurred by employees for medical care. Under Sections 105(b) and 105(e) of the Code, if an accident or health plan was established by an employer for employees, any amounts received under the plan as reimbursement for accident or health expenses was excluded from the income of the employees. The plans were simple to administer

and provided a valuable fringe benefit to employees eligible to participate in such plans.

Without public hearings and, for that matter, without prior discussion, Section 105(h) was added to the Code to impose severe and unprecedented nondiscrimination requirements to noninsured medical expense reimbursement plans. Although some of the new provisions are not onerous, other provisions will lead to termination of such plans and elimination of medical expense reimbursement for all affected employees. The principal objections which our firm, as employee benefit plan advisers and counselors, find in Section 105(h) include the following:

(1) The provisions apply solely to non-insured plans. Insured plans are not subject to the requirements imposed under Section 105(h). Larger employers may continue to provide the same benefits as provided under the plan prior to the enactment of Section 105(h) on an insured basis without significant additional cost. However, small employers may not be able to insure such plans because of cost or underwriting considerations and may end up terminating such plans. Terminating a plan for employees because of these requirements benefits no one.

(2) The Committee Reports indicate that benefits provided under a plan will discriminate in favor of participants who are highly compensated individuals if benefits are based on a percentage of compensation, rather than on a flat dollar limitation for all participants. Thus, the discrimination requirements imposed under this Section, where none appeared before, are more stringent than the discrimination requirements imposed for qualified pension and profit sharing plans, which provide that contributions or benefits may bear a uniform relationship to compensation. We do not believe that more restrictive discrimination requirements should apply to medical expense reimbursement plans than are applied to qualified pension and profit sharing plans under Section 401(a)(5) of the Code.

(3) Because no regulations (proposed or otherwise) under Section 105(h) have been issued by the Treasury Department, employers and employees bear a substantial risk effective January 1, 1980 that if plans do, in fact, discriminate in favor of highly compensated individuals, substantial reimbursements to an employee in the "highly compensated" group will constitute taxable income to the employee, without any additional real compensation to satisfy tax liabilities. This penalty could be significant and many employers are not aware of the impact of these provisions.

(4) The computation of excess reimbursements to highly compensated individuals vis-a-vis other employees will be complex and difficult to determine under Section 105(h)(7). Furthermore, it is not clear from Section 105(h) whether taxable reimbursements to employees are subject to tax withholding requirements or FICA and FUTA requirements.

Many small, closely held companies which maintain non-insured medical expense reimbursement plans for employees may determine that because of the many unanswered questions under Section 105(h), the additional costs involved in amending plans to comply with the requirements of Section 105(h), the additional costs of converting non-insured plans to insured plans, and the additional costs of administering plans subject to the requirements of Section 105(h), it would be better to terminate such plans and provide no medical expense reimbursements to employees, whether highly compensated or not.

Because of the many technical problems and business decisions which must be made in a very short period of time, we urge that the effective date of the provisions of Section 105(h) be deferred until a date not earlier than December 31, 1980, so that the extensive modifications made in Section 105(h) can be more thoroughly reviewed and discussed and so that employers can more carefully review the options available.

I would be happy to discuss the foregoing with any members of the Senate Finance Committee or any of its staff.

Cordially yours,

JOHN R. LINDQUIST.