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INCOME TAX TREATMENT OF CASUALTY LOSSES ATTRIBUTABLE TO MAJOR DISASTERS, ETC.

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

REPORT

[To accompany H.R. 7502]

The Committee on Finance, to which was referred the bill (H.R. 7502) relating to the income tax treatment of certain casualty losses attributable to major disasters, having considered the same, reports favorably thereon with amendments and recommends that the bill as amended do pass.

I. SUMMARY

The first section of H.R. 7502 supplements present law to provide that if property is destroyed or damaged by a storm, flood, fire, or other casualty which is designated by the President of the United States as a major disaster, then, if the losses exceed the gains, both the losses and the gains will be treated as ordinary for tax purposes.

Under present law, uninsured losses on business property (or those from property held for the production of income) arising from a fire or other casualty are treated as ordinary losses without regard to any gains the taxpayer may have. This rule is not changed by the bill. In the case of major disasters, this bill supplements this rule of existing law to provide substantially similar loss treatment for partially insured business property (or property held for the production of income). This loss treatment also is provided in the case of major disasters for losses of personal assets held for more than 6 months (such as a personal residence), whether or not they are covered by any insurance.

In addition, a technical amendment makes it clear that uninsured losses arising from the destruction (in whole or in part), theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held more than 6 months are to be offset against gains otherwise treated as capital gains under section 1231, except to the extent they are specifically excluded from that provision.

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Your committee has added four sections to this bill. One of these (sec. 3 of the bill) provides the $5,000 death benefit exclusion from the income tax, and the estate and gift tax exemptions for employees of universities and certain other tax exempt organizations covered by unfunded retirement programs, in those cases where these employees are granted the option of participating in a funded retirement program. This amendment also provides that the base on which the 20 percent limitation applicable in determining the maximum exclusion in the case of nonqualified annuity contracts in the case of professors and other employees of certain tax-exempt organizations is to include not only contributions with respect to all annuity contracts but also contributions with respect to all other pensions as well (including unfunded plans as well as qualified trusteed plans).

Another provision (sec. 4 of the bill) provides that nonbusiness casualty losses arising from Presidentially designated major disasters are to be deductible with respect to the first $100 of the loss, as well as any amount over $100 (the amounts over $100 are deductible under present law).

Your committee also added a provision (sec. 5 of the bill) which allows a deduction on account of assessments made by a soil or water conservation district for certain purchases of land, easements, et cetera.

The last section added by your committee provides that contributions made to the Local 738, IBT–National Tea Co. Employees' Retirement Fund from May 12, 1958, to May 25, 1959, are to be deductible, and the fund is to be exempt from tax, if it is shown that during that period the fund has not been operated in a manner which would jeopardize the interests of its beneficiaries.

II. REASONS FOR THE BILL

Major disasters; treatment under section 1231.—Generally, under present law (sec. 1231(a) of the code), if the gains on the disposition of certain types of property exceed the losses on this same type of property, the excess is treated in effect as a long-term capital gain. On the other hand, if the losses exceed the gains, then the net loss is treated as an ordinary loss. The long-term gains or losses taken into account for purposes of this computation of net capital gains or net ordinary losses include in general recognized gains or losses from—

1. Sales or exchanges of depreciable property and real estate used in a trade or business; and
2. The compulsory or involuntary conversion of capital assets and depreciable property and real estate used in a trade or business.

Other gains taken into account for this computation include certain income from timber, coal, iron ore, sales of livestock, and unharvested crops.

The Technical Amendments Act of 1958 (sec. 49) provided an exception to the rule described above. It provided that an uninsured loss on property (held for more than 6 months) resulting from fire, storm, shipwreck, or other casualty, or from theft, is not to be netted against gains treated as capital gains (that is, is not to be classified as a sec. 1231 loss) if the property was used in the taxpayer's trade or business or was a capital asset held for the production of income. Thus, as a result of the 1958 amendment, these uninsured losses are deductible against ordinary income and are not required to be netted against gains which otherwise are treated as long-term capital gains.

The 1958 amendment, however, does not apply if the destroyed property is insured in any amount, or if the property, whether or not completely uninsured, is a capital asset not held for the production of income (referred to subsequently as a personal asset) such as the taxpayer's personal residence or nonbusiness automobile. Accordingly, if a casualty loss is partically insured, the loss must be aggregated with various other types of gains and losses covered by section 1231. If the recognized gains on the sales or exchanges plus the recognized gains from involuntary conversions exceed the recognized losses, the net gain is treated in effect as a long-term capital gain. If the losses exceed the gains, the net loss is treated in effect as an ordinary loss deductible from income from other sources.

During the past 2 years, a large number of taxpayers in various parts of the country have suffered severe casualty losses as a result of storms and floods which the President of the United States designated as major disasters for the purposes of the act of September 30, 1950 (42 U.S.C. 1855–1855g). Where the loss is completely uninsured and related to property used in the business or held for the production of income, the taxpayer takes a deduction for the loss against ordinary income, as explained above. But many taxpayers who sustained losses in major disasters had some insurance which reduced but did not eliminate their losses. These taxpayers in many cases can use their losses only to offset long-term capital gains.

Your committee agrees with the House that in the case of a major disaster—a disaster which the President determines is of sufficient severity and magnitude to warrant assistance by the Federal Government to supplement State and local efforts—relief is warranted from the existing treatment of casualty losses not covered by the 1958 amendment.

Major disasters; deduction of casualty losses.—The reasons which have led your committee to agree with the House that relief of the sort provided in the first section of this bill should be granted in the case of presidentially designated major disasters, also caused your committee to conclude that, in those same circumstances, the recently added limit on deductions by individuals of nonbusiness casualty losses (to only those above $100 per casualty) should not apply.

Unfunded annuities.—It has come to your committee's attention that certain universities, whose assets and investments are quite sufficient so it is clear that their obligations to their employees would be met, find it difficult to establish separate funds of assets to cover pension programs for their employees. Also, those universities find that they can provide pension benefits comparable to those obtainable through the purchase of annuity contracts, but at lower cost, if they merely make those benefits a charge upon their general funds. Your committee believes that such educational institutions should not be required to disrupt their investment procedures or purchase commercial annuities in order to be able to provide pension benefits which receive favorable tax treatment for their employees. Accordingly, it has determined to permit unfunded plans (which meet the requirements specified in the bill) to be treated as annuity contracts for certain tax purposes.

Deduction of drainage ditch assessments.—The attention of your committee has been called to a case where an improvement of drainage ditches, etc., of an assessment district has been made necessary by Federal construction on a nearby river. Recognizing the fact that the Federal Government contributed to the necessity for the improvement, Federal funds have been made available for much of the improvement work necessary. However, the assessment district furnished the funds for acquiring easements over land, moving roads, bridges, etc., and assessments were levied against the farmer members to defray such expenditures. The Internal Revenue Service has denied the deduction of the portion of the assessments attributable to such expenditures.

Your committee believes that the type of expenditures referred to above, when made by a soil or water conservation or drainage district and assessed against the farmer members, should be deductible by the farmers since such expenditures, when incurred by an assessment district, can be expected to be used exclusively for soil and water conservation, etc., purposes.

Tax-exempt status for union retirement fund.—Where a pension plan operates for a period as a nonqualified plan before meeting all of the necessary requirements under the Internal Revenue Code, any income it may earn during this period is subject to income tax and any employer contributions made during the period are not deductible. Occasionally it is difficult for a pension trust to achieve qualified status before employer contributions are received by it. Often, considerable time is required to obtain sufficient factual data to establish the actuarial soundness of the plan. Sometimes, also, a technicality may prevent initial compliance with the requirements. In recent years in a number of cases the Congress concluded that this loss of exemption for a fund and the denial of deduction for the employer for a past period was too severe a penalty where it was the intention of both the employers and the employees to qualify the fund, but they failed to do so through inadvertence or for technical reasons, and they in fact operated in the same manner as if they had been qualified trusts. Therefore, the Congress provided in these cases that they were to be considered as qualified, and as exempt funds, in the intervening period between their inception and the time they actually qualified for this treatment, but only if the Secretary of the Treasury or his delegate found that they in the interval had not been operated in a manner to jeopardize the interests of the beneficiaries. In 1964, legislation was approved providing such treatment generally, but only for multiemployer plans. An amendment added by your committee provides the same treatment for the Local 738, IBT-National Tea Company Employees' Retirement Fund (which does not qualify under the 1964 legislation because there is only one employer) for the period beginning May 12, 1958 (the date of the agreement establishing the fund), and ending on May 25, 1959. (The fund has been held to be a qualified trust for years ending after May 25, 1959.)

III. GENERAL EXPLANATION

(a) Casualty losses—treatment under section 1231 (first section of the bill and sec. 1231(a) of the code).—For the reasons given above, the first section of the bill amends section 1231(a) of the Internal Revenue Code to provide that casualty losses of the taxpayer sustained in major disasters are not to be subject to section 1231 if such losses during the taxable year exceed the taxpayer's recognized gains received

on insured property (or received otherwise) destroyed or damaged in a major disaster. The amendment, however, applies only to casualty losses which, but for the amendment, would be subject to section 1231. Thus, uninsured losses on property used in the taxpayer's trade or business (or held for the production of income) are not covered by the amendment since such losses are not subject to section 1231 under existing law (as a result of the last sentence in sec. 1231(a)), whether or not the taxpayer has gains during the taxable year, from insurance received on other property destroyed or damaged, which exceed his uninsured losses.

The amendment applies to property, destroyed or damaged in a major disaster, which is insured in some amount, or which is uninsured but is a personal asset held for more than 6 months, such as a taxpayer's residence.

Under the amendment, if the losses exceed the gains, then both the losses and gains are not subject to section 1231. The losses are then treated as ordinary casualty losses deductible under section 165. The gains are ordinary income since gain from insurance proceeds received on a casualty loss constitute ordinary income rather than capital gain so long as section 1231 is not applicable. (See *Helvering* v. *William Flaccus Oak Leather Co.*, 313 U.S. 247 (1941).) If the gains from insured property destroyed during a major disaster exceed or equal the losses, then both the gains and losses remain subject to the provisions of section 1231. It should be noted that only recognized gains and losses are taken into account. For example, if insurance proceeds are reinvested so that the gain is not recognized under the provisions of section 1033, the gain realized is not taken into account under the amendment.

If a taxpayer has gains or losses during the taxable year attributable to two or more casualties designated by the President as major disasters, then the determination as to whether the losses during the year exceed the gains is not made separately with respect to each major disaster but the gains and losses from all such disasters are aggregated.

The amendment made by the first section of the bill is applicable to taxable years ending after November 30, 1964, so as to cover the storms and floods of December 1964 in the northwestern part of the country.

(*b*) *Insured casualty losses (sec. 2 of the bill and sec. 1231(a) of the code)*.—Section 2 of the bill amends paragraph (2) of section 1231(a) of the code to make it clear that the losses described in paragraph (2) include losses which are not compensated for by insurance or otherwise. However, some uninsured losses described in paragraph (2) are specifically excluded from section 1231 by the sentence which immediately follows paragraph (2)—the sentence which was added at the end of section1231(a) by the Technical Amendments Act of 1958—and which reads as follows:

> In the case of any property used in the trade or business and of any capital asset held for more than 6 months and held for the production of income, this subsection shall not apply to any loss, in respect of which the taxpayer is not compensated for by insurance in any amount, arising from fire, storm, shipwreck, or other casualty, or from theft.

Paragraph (2) of section 1231(a) is amended by the bill because several courts have held that a casualty loss is not subject to the provisions of section 1231 unless the taxpayer receives some property or money as compensation for the loss. (See, for example, *Maurer* v. *United States*, 284 F. 2d 122, where the 10th Circuit Court of Appeals held in 1960 that an uninsured casualty loss of 1954 did not give rise to a sec. 1231 loss; however, the Internal Revenue Service has announced it will not follow this decision and the 4th and 6th Circuit Courts of Appeal have recently agreed with the Internal Revenue Service. *Chewning* v. *Commissioner*, 18 AFTR 2d 5103 (June 22, 1966); *Morrison* v. *United States*, 355 F. 2d 218 (January 25, 1966).)

The amendment described above is consistent with the position taken by Congress in 1958 that uninsured casualty losses are subject to section 1231 unless specifically excluded. In initiating the 1958 amendment which added the sentence which excluded certain uninsured casualty losses from section 1231, the Senate Finance Committee stated (S. Rept. 1983, 85th Cong., p. 204): "On the other hand, the amendment does not apply to loss arising from the destruction or theft of the taxpayer's uninsured personal automobile." Your committee intends that all uninsured losses described in paragraph (2) of section 1231(a) be treated as section 1231 losses unless they are specifically excluded from such treatment by the sentence added to section 1231(a) by the Technical Amendments Act of 1958, or, in the case of major disasters, by the amendment made by the first section of this bill (H.R. 7502).

The amendment made by section 2 of the bill is applicable only in respect to losses sustained after the date of enactment of the act. However, no inference should be drawn from this provision, or its effective date, as to the treatment under prior law of casualty losses arising from uninsured personal assets.

(*c*) *Unfunded annuities, etc.* (*sec. 3 of the bill and secs. 101(b), 403(b), 2039, and 2517 of the code*).—Under present law, retirement plans of universities and certain other tax-exempt organizations must either be qualified plans or be funded through annuity contracts in order for the employees covered under the plan and their beneficiaries to receive certain tax benefits. These benefits are the $5,000 exclusion from income for payments to beneficiaries after an employee's death, the estate tax exclusion, and the gift tax exclusion.

Section 3 of the bill, added by your committee extends these tax benefits to employees and their beneficiaries covered by unfunded retirement plans of universities and other tax-exempt organizations by treating these plans as annuity contracts where certain specified conditions are met.

In the case of the income tax, treating these plans as if they were annuity contracts means that up to $5,000 of payments made upon the employee's death may be treated as nontaxable even though the employee before death had a vested right to the amount if the amount was received within 1 year by reason of his death. For purposes of the estate tax the value of these qualifying annuities is not includible in the gross estate. In the case of the gift tax the exercise of an option by the employer converting one of these qualifying annuities into a joint and survivor annuity is not treated as a transfer subject to gift tax.

An unfunded plan is one which has no segregated funding.[1] For this section 3 treatment to apply, the employees of the university or other organization must (1) have had the option to come under a comparable retirement plan funded by an annuity contract, and (2) the Secretary of the Treasury must have determined that the absence of funding has not materially jeopardized the ultimate payment of the benefits.

This provision applies to taxable years beginning after December 31, 1964, insofar as it relates to the income tax, to decedents dying after December 31, 1964, for estate tax purposes, and to transfers made after the calendar year 1964 for gift tax purposes.

This amendment also modifies the present law provisions applicable in the case of annuity contracts purchased by a tax-exempt educational, et cetera, organization where the contract is not purchased under a qualified plan. While present law permits an exclusion from the income of the employees in this type of case, it limits the overall amount which may be excluded to 20 percent of the compensation paid to the employees. This 20-percent limit under present law applies only to amounts set aside under annuity contracts but includes amounts paid under these contracts whether or not the generally applicable nondiscriminatory coverage requirements are met. The amendment provides that for purposes of computing this 20-percent limit, the value of all of the pension benefits provided by an employer for a teacher, professor, or other employee of one of these tax-exempt organizations is to be taken into account. This includes not only the annuity contracts covered by existing law but also pensions provided under unfunded plans, as well as payments made under qualified trusteed plans.

This 20-percent limitation under present law is computed with respect to the aggregate compensation paid an employee over the years of coverage, taking into account the total contributions made with respect to this aggregate compensation. The amendment provides that the contributions deemed made for purposes of this 20-percent limitation by an employer providing an unfunded plan is to be the amount which would have been paid under a funded plan (based on level premiums) to provide the specified benefits.

This amendment applies to taxable years beginning after December 31, 1965, except that, for purposes of section 101 of the code (relating to certain death benefits), this amendment is treated as applying to taxable years beginning after December 31, 1964; for purposes of section 2039 of the code (relating to estate taxes), this amendment is treated as applying with respect to estates of decedent dying after December 31, 1964; and for purposes of section 2517 of the code (relating to gift taxes), this amendment is treated as applying with respect to calendar years after 1964.

(d) Major disaster casualty losses: $100 limitation (sec. 4 of the act and sec. 165(c) of the code).—The Revenue Act of 1964 added a provision limiting the deduction on account of nonbusiness casualty and theft losses to the amount by which each loss exceeds $100. Section 4 of this bill makes this "$100 deductible" provision inapplicable in the case of losses arising from presidentially designated major disasters of the type to which the first section of this bill applies.

[1] A separate credit on the books of the university does not make a plan funded, for these purposes.

The amendment made by this section applies to taxable years beginning after December 31, 1964.

(*e*) *Soil and water conservation* (*sec. 5 of the bill and sec. 175 of the code*).—Present law permits a farmer to deduct currently certain expenditures for soil or water conservation, or for the purpose of preventing erosion of land. These expenditures include amounts paid or incurred for the moving of earth, leveling, grading and terracing, contour furrowing, the construction of diversion channels, drainage ditches, earthen dams, etc. Deduction is allowed not only for expenditures made directly by the farmer but also for assessments paid by him levied by a soil or water conservation or drainage district to defray expenditures by the district which, if made by the farmer, would be deductible.

Under existing law no deduction may be taken for the purchase or construction of structures, machinery, etc., which are subject to the allowance for depreciation, and the Internal Revenue Service takes the position that expenditures to acquire land, or any easement over land, or to relocate roads or powerlines or other obstructions, in connection with soil or water conservation, are not deductible.

This amendment made by your committee provides for the deduction of assessments levied by a soil or water conservation or drainage district to defray expenditures by such a district in acquiring machines, buildings, land, or any easement over land, or to relocate roads or powerlines or other obstructions, in connection with soil or water conservation purposes.

Your committee's amendment applies to all assessments paid or incurred after December 31, 1963 (whether the expenditures by the district were made before or after that date). While the amendment is not applicable to assessments paid before 1964, your committee does not intend that any inferences should be drawn from the amendment or its effective date as to the treatment under existing law of expenditures made to acquire land or an easement over land, or in relocating roads or powerlines or other obstructions.

Your committee is aware of cases where assessments were paid prior to 1964 which could have been paid in installments, some of which installments would have been payable after 1963. In order to treat alike those people who prepaid and those who paid each installment of the assessment as it became due after 1963, your committee has provided (with respect to the portion of the assessment which is not deductible under existing law) that such amount shall be treated, if the taxpayer so elects, as having been paid when it would have become due if the taxpayer had chosen to pay the assessment in installments rather than in a lump sum. If the taxpayer should die before all of the installments would have become due, any amount remaining at his death to be treated under the election as paid on a subsequent installment due date shall be treated as paid in the year of his death. If the election is made, proper adjustment of the basis of the land used in farming would have to be made to eliminate any amount of the assessment paid before 1964 which under existing law was chargeable to capital account but becomes deductible after 1963 pursuant to the election.

(*f*) *Local 738, IBT-National Tea Co. Employees' Retirement Fund* (*sec. 6 of the bill and secs. 401*(*a*) *and 501*(*a*) *of the code*).—This section, added by your committee, provides that Local 738, IBT-National

Tea Co. Employees' Retirement Fund is to be considered to have been an exempt employees' pension fund (under secs. 401(a) and 501(a) of the Internal Revenue Code) for the period beginning May 12, 1958, and ending May 25, 1959. This section would apply only if it is shown to the satisfaction of the Treasury Department that the trust has, during the above-mentioned period, been operated in the best interests of its beneficiaries.

IV. CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).

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