86TH CONGRESS 2d Session | SENATE | REPORT No. 1083

INCOME TAX TREATMENT OF NONREFUNDABLE CAPITAL CONTRIBUTIONS TO FEDERAL NATIONAL MORTGAGE ASSOCIATION

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Mr. BYRD of Virginia, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 7947]

The Committee on Finance, to whom was referred the bill (H.R. 7947) relating to the income tax treatment of nonrefundable capital contributions to Federal National Mortgage Association, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

On page 2, line 15, strike out "1716" and insert "1718".

On page 3, strike out lines 1 through 3 and insert:

> SEC. 3. (a) The amendment made by the first section of this Act shall apply with respect to taxable years beginning after December 31, 1959. Under regulations prescribed by the Secretary or his delegate, such amendment shall also apply, in the case of any taxpayer, with respect to any taxable year beginning after December 31, 1953, and before January 1, 1960, and ending after August 16, 1954, if the taxpayer—
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> (1) in computing his taxable income for such taxable year (as shown on his return filed not later than the time prescribed by law, including any extension thereof—
>
> (A) claimed a deduction, with respect to the sale of a mortgage to the Federal National Mortgage Association, in respect of any amount of capital contributions evidenced by a share of stock issued pursuant to section 303(c) of the Federal National Mortgage Association Charter Act, or
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> (B) computed the proceeds from such a sale by treating the value of any such share received for

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any such capital contributions as an amount less than the issue price of such share, and

prior to the date of the enactment of this Act, such deduction or treatment has not been disallowed, or, if disallowed, the deficiency attributable thereto has not been paid and has not been used to reduce an overpayment the balance of which (if any) has been refunded or credited; or

(2) after the time prescribed by law for filing his return for such taxable year (including any extension thereof) and prior to the date of the enactment of this Act, claimed a deduction described in paragraph (1)(A) or the treatment described in paragraph (1)(B) (whether by filing a claim for refund or credit in respect of an overpayment, or otherwise), and such deduction or treatment has been allowed and—

(A) an overpayment resulting from such allowance has been refunded or credited, or

(B) a deficiency for such taxable year has been reduced as a result of such allowance and the balance of such deficiency (if any) has been paid.

(b) The amendment made by section 2 of this Act shall apply, in the case of any taxpayer, with respect to any taxable year (whether beginning before, on, or after December 31, 1959), in respect of any share of stock issued pursuant to section 303(c) of the Federal National Mortgage Association Charter Act, only if the amendment made by the first section of this Act applies with respect to the taxable year in which such share was issued.

I. SUMMARY OF BILL

Financial institutions selling mortgage paper to the Federal National Mortgage Association must subscribe to its common stock in an amount equal to 2 percent of the mortgages sold. This stock, which is issued at a par value of $100, has been selling on the market at appreciably less than the issuance price.

This bill provides that where FNMA stock is purchased under these conditions, any excess of the issuance price over the fair market value on the date of issuance is to be treated as an ordinary and necessary business expense in the year of purchase rather than as a part of the cost of acquiring the stock. For the future the year of purchase for this purpose is to be the taxable year in which occurs the date of issuance rather than the date of payment.

As passed by the House the treatment made available by this bill would apply for taxable years beginning after December 31, 1958. Your committee has amended the bill, however, to allow a deduction for these amounts for years after 1959 and also for past years to which the 1954 Code generally applies if for these past years this does not result in a refund or credit attributable to the specific type of expense deduction referred to above.

The Treasury Department has indicated it has no objection to this bill as to its future application.

II. GENERAL STATEMENT

The Federal National Mortgage Association is a mixed-ownership Federal corporation, having on January 1, 1960, preferred stock of $142,820,000 owned by the Federal Government and common stock of $53,319,200 owned by more than 5,800 different private shareholders. The Association was originally chartered by Congress in 1938 and rechartered in 1954. One of its principal purposes is to supplement the general secondary market for home mortgages. As a result, when a financial institution, such as a bank or other mortgage lender or investor desires to obtain more liquid funds, it may sell qualifying mortgages to the Federal National Mortgage Association.

The 1954 act rechartering the Association provided, however, that the Association was to accumulate capital funds by requiring each mortgage seller to make payments of specified amounts of nonrefundable capital contributions to the Association in exchange for capital stock of the Association. Currently, the amount to be paid by a taxpayer-subscriber must equal 2 percent of the unpaid principal of the mortgages he is selling to the Association and for this the Association issues stock on the first day of the succeeding month.

Problems have arisen as to the tax treatment provided for this stock which must be purchased by a taxpayer when he sells mortgage paper to FNMA. The problems have arisen because, although there is a market for the FNMA stock, the market price is appreciably below the stock issuance price, currently the market price being around 55 percent of the issuance price.

Taxpayer-subscribers generally have assumed that any excess of the issuance price over the market price of this stock represented an ordinary and necessary expense incurred in carrying on their trade or business since they acquired the stock in order to sell their excess supply of mortgage paper. In 1958, however, the Internal Revenue Service ruled (Rev. Rul. 58–41, 1958–1 CB 86) that no part of the purchase price of stock of FNMA constituted a deductible business expense. Instead, it was held that the entire amount paid for the stock must be capitalized and treated as the cost of the stock so acquired. Thus, this ruling holds that there is no tax effect at the time of the purchase or issuance of the stock even though the market price of the stock then is substantially below the issuance price. Instead the tax effect occurs only when the stock is sold by the taxpayer.

Your committee believes that it is unfortunate to require the capitalization of these expenditures for FNMA stock by taxpayer-subscribers to the extent they represent the excess of purchase price over market price. Viewed from such a taxpayer's standpoint, the excess appears clearly to be expenditures which he must incur in order to sell the mortgage paper he holds. In view of this, your committee believes that such amounts should be treated as ordinary and necessary expenses incurred in carrying on a trade or business. This, of course, means that in the transaction which occurs when the stock is sold (usually a capital transaction) the basis of the stock should not include this amount previously taken as a deduction.

As a result, the bill adds a new subsection (d) to the section of existing law relating to the deductions of trade or business expenses (sec. 162). The new provision relates to the purchase of FNMA stock

where this stock is purchased in order to sell mortgage paper to the Association. In such cases the bill provides that any excess of the issue price of the stock over its fair market value on the date of issue is to be treated as an ordinary and necessary business expense of that year in carrying on a trade or business. As a result, this excess will be a deduction against ordinary income of the taxpayer for the year the stock is purchased or issued.

The bill also provides that the basis of the FNMA stock is to be reduced by the amount required to be deducted against ordinary income under the new provision. As a result the taxpayer cannot, upon the sale of the stock receive a tax benefit a second time for the amount previously deducted as an ordinary expense item.

The bill as passed by the House was to be effective for taxable years beginning after December 31, 1958. Under your committee's bill this new treatment will be fully available for taxable years beginning after December 31, 1959. However, for years beginning before that time but on or after the general effective date of the 1954 Code (taxable years beginning after December 31, 1953, and ending after August 16, 1954) this amount representing the excess of the purchase price of the FNMA stock over its fair market value is to be available as a deduction except where it would in effect give rise to a new refund or credit (including new reductions in outstanding deficiencies). This is accomplished under your committee's amendments first by not requiring deficiency payments (or reductions in any overpayments) where in computing his initial tax return for the year in question the taxpayer-subscriber either claimed this amount as a deduction (under either sec. 162 or sec. 165) or computed his gross income without taking it into account. Second, your committee's amendment requires no deficiency payments (or reductions in any overpayments) where although the taxpayer-subscriber did not claim this amount (as a deduction or reduction in gross income) he subsequently filed a claim for a refund or credit with respect to this amount and it was allowed by the Internal Revenue Service. The reduction in the basis of the FNMA stock for the excess of its cost over its value is required for stock issued in this past period only if the amount was claimed by the taxpayer-subscriber. By making the new provisions apply back to the effective date in 1954 for the 1954 Code to the extent that they do not result in a credit or refund, your committee's bill will make this new treatment with these exceptions available for all transactions of this type with FNMA, since this requirement to make capital contributions has applied only from the rechartering of the Federal National Mortgage Association in 1954.

CHANGES IN EXISTING LAW

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in Roman):

INTERNAL REVENUE CODE OF 1954

SEC. 162. TRADE OR BUSINESS EXPENSES

(a) IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, Territory, or possession which he represents in Congress shall be considered his home, but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000.

(b) CHARITABLE CONTRIBUTIONS AND GIFTS EXCEPTED.—No deduction shall be allowed under subsection (a) for any contribution or gift which would be allowable as a deduction under section 170 were it not for the percentage limitations, or the requirements as to the time of payment, set forth in such section.

(c) IMPROPER PAYMENTS TO OFFICIALS OR EMPLOYEES OF FOREIGN COUNTRIES.—No deduction shall be allowed under subsection (a) for any expenses paid or incurred if the payment thereof is made, directly or indirectly, to an official or employee of a foreign country, and if the making of the payment would be unlawful under the laws of the United States if such laws were applicable to such payment and to such official or employee.

(b) *CAPITAL CONTRIBUTIONS TO FEDERAL NATIONAL MORTGAGE ASSOCIATION.—For purposes of this subtitle, whenever the amount of capital contributions evidenced by a share of stock issued pursuant to section 303(c) of the Federal National Mortgage Association Charter Act (12 U.S.C., sec. 1718) exceeds the fair market value of the stock as of the issue date of such stock, the initial holder of the stock shall treat the excess as ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.*

[(d)] (e) CROSS REFERENCE.

For special rule relating to expenses in connection with subdividing real property for sale, see section 1237.

Part IV—Special Rules

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SEC. 1054. CERTAIN STOCK OF FEDERAL NATIONAL MORTGAGE ASSOCIATION.

In the case of a share of stock issued pursuant to section 303(c) of the Federal National Mortgage Association Charter Act (12 U.S.C., sec. 1718), the basis of such share in the hands of the initial holder shall be an amount equal to the capital contributions evidenced by such share reduced by the amount (if any) required by section 162(d) to be treated (with respect to share) as ordinary and necessary expenses paid or incurred in carrying on a trade or business.

SEC. [1054] *1055.* CROSS REFERENCES.

(1) For nonrecognition of gain in connection with the transfer of obsolete vessels to the Maritime Administration under section 510 of the Merchant Marine Act, 1936, see subsection (e) of that section, as amended August 4, 1939 (46 U.S.C. 1160).

(2) For recognition of gain or loss in connection with the construction of new vessels, see section 511 of such Act, as amended (46 U.S.C. 1161).

(3) For nonrecognition of gain in connection with vessels exchanged with the Maritime Administration under section 8 of the Merchant Ship Sales Act of 1946, see subsection (a) of that section (50 U.S.C. App. 1741).

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