Calendar No. 1166

96TH CONGRESS } SENATE { REPORT
2d Session } { No. 96-1034

SECOND-TIER EXCISE TAXES

REPORT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ON

H.R. 5391

NOVEMBER 25 (legislative day, NOVEMBER 20), 1980.—Ordered to be printed

U.S. GOVERNMENT PRINTING OFFICE
69-674 O WASHINGTON : 1980

CONTENTS

	Page
I. Summary	2
II. Explanation of the Bill	4
A. Second-tier excise taxes	4
B. Alternative minimum tax on charitable lead trusts created by corporations	6
C. Adjustments in excise tax on tires	7
D. Extension of cash and deferred plan rules to salary reduction arrangements under money purchase pension plans	9
E. Tax treatment of Klamath Indian judgments	11
III. Effect of the Bill on the Budget and Vote of the Committee in Reporting the Bill, as Amended	12
IV. Regulatory Impact of the Bill	13
V. Changes in Existing Law Made by the Bill, as Reported	13

Calendar No. 1166

96TH CONGRESS 2d Session | SENATE | REPORT No. 96-1034

SECOND-TIER EXCISE TAXES

NOVEMBER 25 (legislative day, NOVEMBER 20), 1980.—Ordered to be printed

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

REPORT

[To acompany H.R. 5391]

The Committee on Finance, to which was referred the act (H.R. 5391) to amend chapter 42 of the Internal Revenue Code of 1954 with respect to the determination of second-tier taxes, having considered the same, reports favorably thereon with an amendment and an amendment to the title and recommends that the act as amended do pass.

The amendment is shown in the text of the bill in italic.

House bill.—H.R. 5391, as passed by the House, provided that the Tax Court is to have jurisdiction over second-tier excise taxes relating to private foundations, employee benefit trusts, and black lung benefit trusts, with respect to prohibited acts of these organizations.

Committee bill.—The committee bill retains the House provision relating to second-tier excise taxes, and adds four other tax provisions relating to (1) alternative minimum tax on charitable lead trusts created by corporations (sec. 3 of H.R. 4746, as passed the House), (2) adjustments in excise taxes on tires, (3) cash and deferred plan rules for salary reduction arrangements under money purchase pension plans (previously reported by the committee in sec. 406 of H.R. 1212 and H.R. 2492), and (4) tax treatment of Klamath Indian judgments.

I. SUMMARY

Section 2. Second-Tier Excise Taxes

Under present law, a two-tier excise tax system is applicable to private foundations, employee benefit trusts, and black lung benefit trusts, with respect to prohibited acts of these organizations. The second-tier excise tax is not imposed if the prohibited act is corrected within a correction period. The Tax Court has held that it has no jurisdiction to redetermine a deficiency for a second-tier tax because the tax is not imposed until after its decision is final.

Under the bill, the second-tier excise tax will be imposed before any litigation begins (in order to insure that the Court will have jurisdiction) but is to be forgiven if the prohibited act is corrected within a correction period.

Section 3. Alternative Minimum Tax on Charitable Lead Trusts Created by Corporations

Under present law, the alternative minimum tax may be imposed on a charitable lead trust set up by a corporation because the deduction for income paid to charity is treated as an adjusted itemized deduction preference. However, if the corporation had made a contribution to charity directly instead of through a charitable lead trust, there would be no alternative minimum tax because corporations are not subject to this tax.

This section of the bill provides that the charitable deduction of a charitable lead trust will not be considered in determining the adjusted itemized deduction preference for purposes of the alternative minimum tax if the grantor of the trust and the owner of all reversionary interests in the trust is a corporation.

Section 4. Adjustments in Excise Tax on Tires

Present law imposes an excise tax of 10 cents per pound on new highway tires (to be reduced to 5 cents per pound on October 1, 1984), and 5 cents per pound on new nonhighway tires. A credit or refund is allowed with respect to tires for which a warranty or guarantee adjustment is made. However, there are no specific statutory provisions as to the proper method of computing the credit or refund.

The bill will reduce the excise taxes on new tires by 2.5 percent, beginning on January 1, 1981, and disallow an excise tax credit or refund with respect to tires for which a warranty or guarantee adjustment is made after December 31, 1982. The bill also provides a special rule for determining a credit or refund for tires which are adjusted after March 31, 1978, and prior to January 1, 1983. In this period, a credit or refund would be determined under the administrative guidelines in effect on March 31, 1978.

Section 5. Extension of Cash and Deferred Plan Rules to Salary Reduction Arrangements Under Money Purchase Pension Plans

The Revenue Act of 1978 provided rules for new and old profit-sharing and stock bonus plans with cash and deferred arrangements. No rules were provided for money purchase pension plans with salary reduction arrangements.

The bill provides that salary reduction arrangements under money purchase pension plans which were in existence on June 27, 1974, would be included under the 1978 Revenue Act rules applicable to cash-and-deferred arrangements under profit-sharing and stock bonus plans. However, the percentage-of-compensation contribution formula in money purchase pension plans in existence on June 27, 1974, may not to be higher than it was on that date.

Section 6. Tax Treatment of Klamath Indian Judgments

Under present law, the income tax treatment of interest or damages for delay in payment for the Klamath Reservation is unclear.

The bill clarifies that interest or damages for delay in payment for the Klamath Reservation are excludible from the income of the Klamath trust and its distributees.

II. EXPLANATION OF THE BILL

A. Second-Tier Excise Taxes (sec. 2 of the bill and secs. 4941, 4942, 4943, 4944, 4945, 4951, 4952, 4961, 4971, 4975, 6213, 6214, 6503, and 7422 of the Code)

Present law

Under present law, the Internal Revenue Code contains nine sections which impose a two-tier excise tax system to insure the compliance of private foundations,[1] pension trusts,[2] and black lung benefit trusts[3] with certain provisions of the Code. Under each of the sections, a first-tier excise tax is imposed automatically if the foundation or trust engages in a prohibited act (such as self dealing between a disqualified person and a private foundation), and a much larger second-tier excise tax is imposed for failing to correct the prohibited act within a "correction period." The "correction period" ends after the time a court decision as to whether the taxpayer is liable for the second-tier tax becomes final. This system is designed to provide an adequate opportunity for court review and correction of the transaction before the Internal Revenue Service can impose the second-tier tax. The second-tier taxes are intended to be sufficiently high to compel voluntary compliance (at least after court review) with these provisions.

In a recent case,[4] the Tax Court held that it lacked the authority to redetermine a deficiency of a second-tier tax with respect to an act of self dealing by a private foundation under Code section 4941(b). The Court found that because the second-tier tax is not "imposed" until after its decision is final, it did not have jurisdiction to redetermine a deficiency of that tax. In addition, the Court noted that the "amount involved" (upon which the amount of tax is based) cannot be determined until after the decision has become final.

Reasons for change

The committee believes that the two-tier excise tax system for prohibited acts by private foundations, pension trusts, and black lung trusts should be amended in order to insure the courts have jurisdic-

---

[1] The provisions relating to private foundations are Code sections 4941 (self-dealing), 4942 (failure to distribute income), 4943 (excess business holdings), 4944 (jeopardy investments), and 4945 (taxable expenditures). These provisions were added by the Tax Reform Act of 1969.

[2] The provisions relating to pension trusts are Code sections 4971 (minimum funding) and 4975 (prohibited transactions). These provisions were added by the Employee Retirement Income Security Act of 1974.

[3] The provisions relating to black lung benefit trusts are Code sections 4951 (self-dealing) and 4952 (taxable expenditures). These provisions were added by the Black Lung Benefits Revenue Act of 1977.

[4] *Adams* v. *Commissioner*, 72 T.C. 81 (1979). This decision was followed in two subsequent cases: *Larchmont* v. *Commissioner*, 72 T.C. 131 (1979), and *H. Fort Flowers Foundation* v. *Commissioner*, 72 T.C. 399 (1979). No inference is intended as to the correctness of these decisions under present law.

tion to enforce the second-tier taxes. In addition, the committee believes that any changes to this system should continue the original intent of the Congress to provide adequate opportunity for court review and correction of any transaction before requiring the taxpayer to pay the second-tier tax.

Explanation of provision

Under the bill, the second-tier excise tax is to be imposed at the end of the taxable period (i.e., the time the Internal Revenue Service mails a notice of deficiency to the taxpayer with respect to the first-tier tax or when the first-tier tax is assessed if no deficiency notice is mailed). However, the second-tier tax is not to be assessed if the taxpayer files a petition with the Tax Court to redetermine that tax and the taxpayer corrects the prohibited act by the end of the correction period. Under the bill, the correction period is to end when the decision of the Tax Court becomes final (under Code sec. 7481), except that it is to be extended by any period the IRS determines is reasonable and necessary to bring about correction (Code sec. 4962(e)).[5]

The bill also provides for a supplemental proceeding by the Court to determine whether the taxpayer corrected the prohibited act within the correction period, if the Court previously determined that the second-tier tax was properly imposed.

Thus, where the taxpayer petitions the Tax Court to redetermine a second-tier tax, the tax may not be assessed unless the Court decides (including a decision in any supplemental proceeding) that the taxpayer has engaged in an act giving rise to a first-tier tax and that the act was not timely corrected.

In refund cases, the bill suspends the collection of any second-tier excise tax which was assessed (for example, because a notice of deficiency was mailed and no petition was filed with the Tax Court) until the taxpayer completes its administrative and judicial refund procedures. Thus, a taxpayer may have a U.S. district court or the Court of Claims review issues involving the second-tier tax without first being required to pay the second-tier tax.[6]

Finally, the bill provides that the amount of the second-tier taxes on self-dealing (Code secs. 4941, 4951, and 4975) will be fixed in amount on the date the second-tier tax is imposed.

Effective date

The bill applies to second-tier taxes assessed after the date of enactment of the bill (except in cases where a court decision with respect to which res judicata applies on that date).

Revenue effect

These provisions will not have any effect on budget receipts.

---

[5] It is expected that the IRS will use this authority to provide a reasonable period following the finality of a court decision against a taxpayer to allow the taxpayer to correct the transaction.

[6] Under Treasury regulations, the correction period is extended during the pendency of refund proceedings. Under Code section 7422(g)(1), the jurisdictional requirement that a taxpayer pay the second-tier tax is waived.

B. Alternative Minimum Tax on Charitable Lead Trusts Created by Corporations (sec. 3 of the bill and sec. 57 of the Code)

Present law

The Revenue Act of 1978 imposed an alternative minimum tax with rates up to 25 percent on taxpayers other than corporations. Alternative minimum taxable income is gross income reduced by allowable deductions and increased by the amount of the taxpayer's adjusted itemized deductions and capital gains deduction. The preference for adjusted itemized deductions is generally the amount by which a taxpayer's itemized deductions (such as the charitable deduction) exceed 60 percent of the taxpayer's adjusted gross income. In general, the preference for adjusted itemized deductions was applied to charitable lead trusts (i.e., where the present interest in the trust is paid to the charity) in order that this type of trust could not be used to circumvent application of the alternative minimum tax to the grantor (or beneficiary) of the trust. Exceptions were provided where avoidance of the alternative minimum tax was not possible, e.g., estates, testamentary charitable lead trusts, and trusts created before 1978. However, no exception was provided for charitable lead trusts created by a corporation even though corporations are not subject to the alternative minimum tax. Consequently, the alternative minimum tax may be imposed on a charitable lead trust created by a corporation because the trust's charitable deduction for income paid to charity may give rise to the preference for adjusted itemized deductions.

Reasons for change

The committee believes that, for purposes of the alternative minimum tax, the treatment of the charitable deduction of a charitable lead trust, created by a corporation and in which a corporation has the reversionary interest, should be consistent with the treatment of a charitable deduction when the contribution is directly made by a corporation.

Explanation of provision

The bill provides that the charitable contribution deduction of a charitable lead trust will not be treated as an itemized deduction in determining the adjusted itemized deduction preference for purposes of the alternative minimum tax, if the grantor of the trust and the owner of all reversionary (or remainder) interests in the trust is a corporation.

Effective date

This provision is effective for taxable years beginning after December 31, 1975.[1]

Revenue effect

This provision will reduce budget receipts by less than $5 million annually.

---

[1] The amendment applies to all taxable years for which itemized deductions may be treated as a preference for minimum tax purposes. Preference treatment was first provided for certain itemized deductions under the Tax Reform Act of 1976.

C. Adjustment in Excise Tax on Tires (sec. 4 of the bill and secs. 4071 and 6416 of the Code)

Present law

Present law (sec. 4071(a) of the Code) imposes a manufacturers excise tax of 10 cents per pound on new tires[1] of the type used on highway vehicles, and 5 cents per pound on new nonhighway tires. The tax on new highway tires is scheduled to be reduced to 5 cents per pound on October 1, 1984 (sec. 4071(d)); the tax on nonhighway tires is to remain at 5 cents per pound. Revenues from the tax on tires go into the Highway Trust Fund (through September 30, 1984).

Since these taxes are imposed on the basis of the weight of the tire, the price for which the tire is sold generally does not affect the amount of tax due on a manufacturer's sale. However, under IRS administrative guidelines (Rev. Rul. 59-394, 1959-2 CB 280), an exception occurs when a tire manufacturer sells a new replacement tire at a reduced price pursuant to a warranty or guarantee on the tire that is being replaced. Then the manufacturers excise tax on the replaced tire is to be reduced in proportion to the reduction in price of the replacement tire. The amount is allowable as a credit or refund (without interest) of the manufacturers excise tax on the replaced tire (sec. 6416(b)).

The tire industry's practice has been to apply this rule based on the proportionate reduction in the price to the ultimate consumer where the warranty or guarantee is invoked by the ultimate consumer. This reduction is often greater than the reduction in the price of the replacement tire by the manufacturer to the dealer who provides the replacement tire to the ultimate consumer. However, the Internal Revenue Service has taken the position (Rev. Rul. 76-423, 1976-2 CB 345) that the tax should be reduced in proportion to the reduction in price from the manufacturer to its immediate vendee—usually, a wholesaler or a dealer. Under current warranty or guarantee practices used in the tire industry, the Service's position generally produces a smaller tax reduction (hence, a larger net tax) than that produced by a rule that is based on the adjustment in the sale price to the ultimate consumer.

Revenue Ruling 76-423 also provides similar rules for the situation where the manufacturer's warranty or guarantee runs to the dealer but not to the ultimate consumer, and where the replacement tire is not from the same manufacturer as the original tire being returned under the warranty or guarantee. Finally, the ruling provides that, where the manufacturer initially sells tires to a dealer "under a price reduction arrangement in lieu of a warranty," no adjustment in excise tax is allowable.

---

[1] The tax applies on the sale (sec. 4071(a) (1) and (2)) or delivery to a retail outlet (sec. 4071(b)) of a manufacturer, producer or importer. (A lease (sec. 4217) or use (sec. 4218) is treated as a sale for these purposes.) In general, this means that, as to domestically manufactured tires, the tax applies to new tires and also to tires that have been retreaded "from bead to bead" (thereby making them new articles). As to imported tires, the tax applies whether or not the tire is new, if the tire has not previously been taxed in the United States. Tires on imported articles (other than articles taxed under sec. 4061 as trucks, etc.) also are subject to tax.

As originally announced, the 1976 ruling was to have taken effect with respect to this issue on April 1, 1977. After having been twice postponed by the Service, the effective date of the 1976 ruling became April 1, 1978.

Reasons for change

The committee believes that the maufacturers excise tax on new tires can be simplified significantly. This can be accomplished by reducing the rate of excise tax applicable to new tires and by simultaneously phasing out excise tax credits and refunds with respect to tires the price of which is adjusted pursuant to a warranty or guarantee. By the time that the excise tax credit or refund phaseout has been completed, these changes should result in a simplified system without having a significant effect on the overall receipts from the excise tax on tires.

Because the committee has decided to phase out excise tax credits and refunds with respect to new tires, it believes that the established practices utilized by the tire industry prior to the effective date of Rev. Rul. 76–423 should remain in effect. This will eliminate a need to implement new procedures for the duration of the short phaseout period.

Explanation of provision

The bill will reduce the rate of manufacturers excise tax on new tires by 2.5 percent, beginning on January 1, 1981. Thus, the tax on new highway tires will be reduced to 9.75 cents per pound on January 1, 1981, and to 4.875 cents per pound on October 1, 1984 (when the tax is scheduled to be reduced to 5 cents per pound under present law); and the tax on new nonhighway tires will be reduced to 4.875 cents per pound on January 1, 1981.

The bill also provides a special rule for the determination of an excise tax credit or refund with respect to tires for which a warranty or guarantee adjustment is made. For the adjustment of any tire after March 31, 1978, and prior to January 1, 1983, a credit or refund would be determined under the practice used by the industry prior to the effective date of Rev. Rul. 76–423. No credit or refund would be allowed for a warranty or guarantee adjustment of any tire after December 31, 1982.

Effective date

The amendments relating to excise tax rates apply for new tires sold after December 31, 1980.

The provisions relating to the determination of an excise tax credit or refund apply to the adjustment of any tire after March 31, 1978, and prior to January 1, 1983.

The amendments relating to disallowance of an excise tax credit or refund apply to the adjustment of any tire after December 31, 1982.

Revenue effect

Because this provision will reduce excise tax rates on new tires for two years before it disallows credits or refunds, it is estimated that the bill will decrease net excise tax receipts (receipts less credits and refunds) by $15 million in fiscal year 1981, by $20 million in fiscal year 1982, and by $5 million in fiscal year 1983. The provision will have negligible effects on net receipts after fiscal year 1983. (These amounts otherwise would go into the Highway Trust Fund—through September 30, 1984).

D. Extension of Cash and Deferred Plan Rules to Salary Reduction Arrangements Under Money Purchase Pension Plans (sec. 5 of the bill and sec. 401(k) of the Code)

Present law

The Employee Retirement Income Security Act of 1974 (ERISA) permitted the Treasury to deny favorable tax treatments to cash and deferred arrangements under profit-sharing, stock bonus, or money purchase pension plans with salary reduction arrangements, if the plans were not in existence on June 27, 1974. ERISA preserved the tax treatment of plans in existence on that date, pending study by the Congress of the appropriate treatment of these plans. The protection for plans in existence on June 27, 1974, was originally provided for contributions made before January 1, 1977. This protection has since been extended until January 1, 1980.

The Revenue Act of 1978 provided rules for new and old profit-sharing and stock bonus plans with cash or deferred arrangements. The new rules apply for plan years beginning after December 31, 1979. For years beginning before January 1, 1980, the tax treatment under a plan in existence on June 27, 1974, is determined under prior law. No rules were provided for salary reduction arrangements under money purchase pension plans by the 1978 Act.

Reasons for change

Many tax-exempt organizations have money purchase pension plans with a salary reduction feature. Because such organizations are generally precluded from adopting profit-sharing plans or stock bonus plans, they would like to continue in existence these money purchase pension plans. Profit-sharing plans and stock bonus plans, which are generally available to, and adopted by, taxable employers, permit a cash or deferred option which is similar to a salary reduction arrangement.

Explanation of provision

Under the bill, a money purchase pension plan in existence on June 27, 1974, which provided for a salary reduction arrangement on that date will be permitted to continue the arrangement after December 31, 1979. However, under the bill, these plans may not increase the level of either employer or employee contributions under a salary reduction arrangement (e.g., as a percentage of total compensation or a fixed dollar amount) above the level in effect under that arrangement on June 27, 1974. In addition, for plan years beginning on or after January 1, 1980, these money purchase pension plans must satisfy the standards applicable to cash or deferred profit-sharing and stock bonus plans relating to (1) employee participation and (2) discrimination in favor of employees who are officers, shareholders, or highly compensated. The provisions of the bill apply to businesses as well as tax-exempt organizations.

Effective date

The provision applies for plan years beginning after December 31, 1979. However, the portion of the amendment relating to the tax treatment of contributions will apply for contributions made after December 31, 1979. A transition rule is provided for contributions made after December 31, 1979, and before the beginning of the first plan year beginning after that date.

Revenue effect

It is estimated that this provision will decrease budget receipts by less than $1 million annually.

E. Tax Treatment of Klamath Indian Judgments (sec. 6 of the bill)

Present law

In 1954, Congress authorized the sale of the Klamath Reservation, and ended Federal recognition of the tribe. Termination of the tribe occurred in 1958–9. Under the terms of the terminating legislation, any distribution to a member of the tribe of his share in tribal lands, whether in cash or not, would be free from tax. Klamath Indians were given the option to withdraw their share of the value of the tribal lands, or to remain as owners of a private trust to hold their share of the land. Seventy-eight percent of the Klamath Indians chose to withdraw their share. Twenty-two percent chose to leave their interest in the trust.

In 1969, the remaining Klamaths decided to terminate the trust. The property was condemned by the Federal Government and added to the Winema National Forest.

The amount distributed to the remaining Klamaths would have been subject to capital gains tax, to the extent it exceeded the amount that would have been distributed to a withdrawing Indian in 1959–61. Therefore, the remaining Klamath Indians would have been subject to tax, while the withdrawing Indians were not. To prevent this result, Congress enacted P.L. 94–81, which provided that gain from the condemnation would be excluded from the trust's income and from the income of each person receiving a distribution of the condemnation proceeds from the trust.

Because of litigation over the value of the land, final payment by the United States was not made until this year. The judgment consisted of $103,000,000 for the property plus $27,540,000 as interest or damages for delay in payment since 1974.

Reasons for change

The committee believes that it should clarify that the interest portion of the judgment, in this case, is exempt from income taxation.

Explanation of provision

The provision clarifies that the portion of the Klamath Indian judgment representing interest or damages for delay in payment also is excludible from the income of the trust and its distributees. The exclusion, however, does not extend to income (if any) earned by the trust or the beneficiaries on the condemnation proceeds.

Effective date

The provision will apply to all amounts received before, on, or after enactment.

Revenue effect

It is estimated that the provision will reduce budget receipts for fiscal year 1981 by less than $10 million.

III. EFFECT OF THE BILL ON THE BUDGET AND VOTE OF THE COMMITTEE IN REPORTING THE BILL AS AMENDED

Budget Effect

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made about the effect on the budget of this bill, H.R. 5391, as amended. The committee estimates that the bill will reduce budget receipts by $24 million in fiscal year 1981, $24 million in fiscal year 1982, $9 million in fiscal year 1983, $4 million in fiscal years 1984 and 1985.

The Treasury Department agrees with this statement.

New Budget Authority and Tax Expenditures

In accordance with section 308 of the Budget Act, after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by this bill involve no new budget authority and no new or increased tax expenditures.

Consultation with Congressional Budget Office on Budget Estimates

In accordance with section 403 of the Budget Act, the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates (as indicated above) and agrees with the methodology used and the resulting revenue estimates.

Vote of the Committee

In compliance with paragraph 7(c) of Rule XXVI of the Standing Rules of the Senate, the following statement is made about the vote of the committee on the motion to report the bill, as amended. The bill, H.R. 5391, as amended, was ordered favorably reported by voice vote.

IV. REGULATORY IMPACT OF THE BILL

In compliance with paragraph 11 (b) of Rule XXVI of the Standing Rules of the Senate, the following statement is made concerning the regulatory impact that might be incurred in carrying out the provisions of this bill, H.R. 5391, as reported by the committee.

Individuals and businesses regulated and economic impact of regulation.—The bill does not regulate any individuals or businesses, but amends and clarifies certain provisions of the tax law. The bill amends the two-tier excise tax with respect to various organizations, eliminates the consideration of the charitable deduction in determining the adjusted itemized deduction preference of charitable lead trusts created by corporations, reduces the new tire excise tax and eliminates recomputations and refunds of that tax, provides rules for money purchase pension plans with salary reduction arrangements, and clarifies the tax treatment of interest and damages for delay in payment for the Klamath Reservation.

Impact on personal privacy.—The provisions of the bill will have minimal impact on personal privacy.

Determination of paperwork involved.—The provisions of the bill will reduce the tax reporting and other paperwork of persons involved in the administration of corporate charitable lead trusts, the administration of certain money purchase pension plans, manufacturing new tires, and administering the two-tier excise tax.

V. CHANGES IN EXISTING LAW MADE BY THIS BILL, AS REPORTED

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill. H.R. 5391, as reported by the committee).

O